Hawaii Health Systems Corporation

Financial Report
with Other Supplemental Information
June 30, 2012

Hawaii Health Systems Corporation

Contents

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Independent Auditor's Report

To the Board of Directors
Hawaii Health Systems Corporation

We have audited the accompanying financial statements of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of and for the years ended June 30, 2012 and 2011, as listed in the table of contents. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only HHSC (a component unit of the State of Hawaii) and do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2012 and 2011, the changes in its financial position, or its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hawaii Health Systems Corporation at June 30, 2012 and 2011 and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, in fiscal year 1997, the administration of the facilities that comprise HHSC was transferred from the State Department of Health - Division of Community Hospitals (the "State") to HHSC. At June 30, 2012, negotiations between the State and HHSC relating to the transfer of HHSC's assets and liabilities (including amounts to the State) still had not been finalized. Accordingly, the assets, liabilities, and net assets reflected in the accompanying balance sheet at June 30, 2012 and 2011 may be significantly different from those eventually included in the final settlement.

To the Board of Directors
Hawaii Health Systems Corporation

The management's discussion and analysis is not a required part of the financial statements but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements that collectively comprise Hawaii Health Systems Corporation's financial statements. The accompanying other supplemental information, as identified in the table of contents, is presented for the purpose of additional analysis and is not a required part of the financial statements. The other supplemental information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 11, 2013 on our consideration of Hawaii Health Systems Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Plante & Moran, PLLC

January 11, 2013

This discussion and analysis of Hawaii Health Systems Corporation's (HHSC or the "Corporation") financial performance provides an overview of the Corporation's financial activities for the fiscal years ended June 30, 2012, 2011, and 2010. Please read it in conjunction with the Corporation's financial statements, which begin on page 15.

Using this Annual Report

The Corporation's financial statements consist of three statements: (a) a balance sheet, (b) a statement of revenue, expenses, and changes in net assets, and (c) a statement of cash flows. These financial statements and related notes provide information about the activities of the Corporation, including resources held by the Corporation but restricted for specific purposes.

The Balance Sheet and Statement of Revenue, Expenses, and Changes in Net Assets

- The analysis of the Corporation's finances begins on page 4. One of the most important questions asked about the Corporation's finances is, "Is the Corporation as a whole better or worse off as a result of the year's activities?" The balance sheet and the statement of revenue, expenses, and changes in net assets report information about the Corporation's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenue and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Corporation's net assets and changes in them. You can think of the Corporation's net assets - the difference between assets and liabilities - as one way to measure the Corporation's financial health or financial position. Over time, increases or decreases in the Corporation's net assets are one indicator of whether its financial health is improving or deteriorating. You will need to consider other nonfinancial factors, however, such as changes in the Corporation's patient base and measures of the quality of service it provides to the community, as well as local economic factors, to assess the overall health of the Corporation.

The Statement of Cash Flows

The final required statement is the statement of cash flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities. It provides answers to such questions as, "Where did cash come from?," "What was cash used for?," and "What was the change in cash balance during the reporting period?"

The Corporation's Net Assets

The Corporation's net assets are the difference between its assets and liabilities reported in the balance sheet. The Corporation's net assets decreased by $40,719,703 (32 percent) in 2012, increased by $207,829 (.16 percent) in 2011, and decreased by $36,452,169 (39.4 percent) in 2010, as you can see from the following table.

Assets, Liabilities, and Net Assets

Summarized financial information of HHSC's balance sheet as of June 30, 2012, 2011, and 2010 is as follows:

	2012	2011	2010
Assets			
Current assets	$ 226,346,844	$ 216,565,876	$ 195,301,745
Capital assets - Net	309,561,477	291,103,090	285,585,332
Other assets	12,011,753	4,579,301	3,242,628
Total assets	**$ 547,920,074**	**$ 512,248,267**	**$ 484,129,705**
Liabilities			
Current liabilities	$ 127,641,898	$ 112,587,993	$ 115,208,849
Other postemployment liability	196,718,378	143,024,739	105,204,848
Due to the State of Hawaii	42,122,507	41,622,507	44,122,507
Other liabilities	93,093,697	85,949,731	90,738,033
Total liabilities	459,576,480	383,184,970	355,274,237
Net Assets (Deficit)			
Invested in capital assets - Net of related debt	250,810,573	238,189,336	222,054,782
Restricted	663,192	902,579	1,107,015
Unrestricted	(163,130,171)	(110,028,618)	(94,306,329)
Total net assets	88,343,594	129,063,297	128,855,468
Total liabilities and net assets	**$ 547,920,074**	**$ 512,248,267**	**$ 484,129,705**

At June 30, 2012, 2011, and 2010, HHSC's current assets approximated 41 percent, 42 percent, and 40 percent of total assets, respectively. Current assets increased approximately $9.8 million in 2012 due to increases in patient accounts receivable of $19.1 million and estimated third-party payor settlements from Medicare and Medicaid of $5.1 million, which were partially offset by the decrease in cash and cash equivalents of $18.4 million. The increase in patient accounts receivable was due to the efforts related to implementation of an electronic medical records (EMR) system whereby billing and collection staff were reallocated to the EMR project. The increase in settlements expected from Medicare and Medicaid of $5.1 million is primarily due to the timing of the Medicaid uncompensated care payment. The decrease in cash and cash equivalents of $18.4 million is primarily due to various factors, as reflected in the statement of cash flows. The reasons for this change are discussed in the Operating Results and Changes in Net Assets section below.

The primary reason for the increase in current assets in 2011 was due to increases in the due from State of Hawaii of $15.1 million and cash and cash equivalents of $10.7 million, which were partially offset by the decrease in estimated settlements from Medicare and Medicaid of $5.9 million. The increase in the amounts due from the State of Hawaii is due to allotments to HHSC for State-funded capital improvement projects in excess of amounts expended. All amounts due from the State of Hawaii represent the outstanding balance of allotments, claims, and encumbrances relating to HHSC's state-funded construction projects. The increase in cash and cash equivalents of $10.7 million is primarily due to various factors, as reflected in the statement of cash flows. The decrease in settlements expected from Medicare and Medicaid of $5.9 million is primarily due to the timing of payments received in 2011 related to the DHS supplemental payments.

At June 30, 2012, 2011, and 2010, HHSC's current liabilities were approximately 28 percent, 29 percent, and 32 percent of total liabilities, respectively. The primary reason for the increase in current liabilities in 2012 of $15.1 million is due to the increase in accounts payable and accrued expenses $16.9 million, which was the result of the efforts related to the EMR implementation and the decrease in funding from the State of Hawaii. Billing and collection staff were reallocated to the EMR project, which negatively affected cash collections of patient accounts receivable, thereby causing HHSC to stretch the payment time to vendors for accounts payable and accrued expenses. The primary reason for the decrease in current liabilities in 2011 of $2.6 million is due to the decrease in the current portion of long-term debt of $4.6 million and the decrease in the capital lease obligation of $1.6 million, which were both due to repayments in 2011. The decrease was partially offset by increases in the current portion due to the State of Hawaii of $2.5 million and accounts payable and accrued expenses of $1.5 million. The increase in the current portion due to the State of Hawaii is the result of impending maturity of the advance from the State of Hawaii. The increase in accounts payable and other accrued expenses is due to increases in operating expenses in 2011, coupled with the decrease in funding from the State of Hawaii.

At June 30, 2012, 2011, and 2010, HHSC's net assets are reflected as its investment in capital assets, net of related debt of approximately $251 million, $238 million, and $222 million, respectively. Total net assets were $88 million in 2012 and $129 million in 2011 and 2010.

Capital Assets

At June 30, 2012, 2011, and 2010, HHSC's capital assets, net of accumulated depreciation, comprised approximately 56 percent, 57 percent, and 59 percent of its total assets, respectively. These assets consist mainly of land, hospital buildings, and equipment that are used in HHSC's operations. The increase of approximately $18.5 million in 2012, $5.5 million in 2011, and $8.9 million in 2010, respectively, is due primarily to ongoing construction projects, particularly the EMR project in 2012.

A summary of HHSC's capital assets as of June 30, 2012, 2011, and 2010 is as follows:

	2012	2011	2010
Land and land improvements	$ 6,456,524	$ 6,483,834	$ 6,483,834
Building and improvements	392,899,001	376,906,867	353,427,467
Equipment	174,780,856	160,299,322	148,669,328
Construction in progress	31,402,877	21,485,947	31,223,642
Total capital assets	605,539,258	565,175,970	539,804,271
Less accumulated depreciation and amortization	(295,977,781)	(274,072,880)	(254,218,939)
Capital assets - Net	**$ 309,561,477**	**$ 291,103,090**	**$ 285,585,332**

Long-term Debt and Capital Lease Obligations

At June 30, 2012 and 2011, HHSC had long-term debt and capital lease obligations totaling approximately $66.8 million and $61.0 million, respectively. The increase of $5.8 million in 2012 was primarily due to HHSC entering into capital lease obligations of $16.1 million that were mainly related to the EMR project. The increase was partially offset by repayments of both long-term debt and capital lease obligations of $10.3 million in 2012. In 2011, HHSC repaid approximately $14.1 million on outstanding long-term debt and capital lease obligation arrangements. More detailed information about HHSC's long-term debt and capital lease obligations is presented in the notes to the financial statements.

Operating Results and Changes in Net Assets

Summarized financial information of HHSC's statement of revenue, expenses, and changes in net assets for the years ended June 30, 2012, 2011, and 2010 is as follows:

	2012	2011	2010
Operating revenue	$ 524,674,715	$ 488,382,320	$ 471,177,026
Operating expenses:			
Salaries and benefits	419,534,023	377,762,380	369,281,680
Purchased services and professional fees	81,190,116	69,056,744	59,169,765
Medical supplies and drugs	70,171,139	64,202,837	60,578,206
Depreciation and amortization	27,261,446	24,118,505	22,916,734
Insurance	5,465,887	6,316,661	7,695,836
Other	64,514,649	58,734,535	52,668,466
Total operating expenses	668,137,260	600,191,662	572,310,687
Operating loss	(143,462,545)	(111,809,342)	(101,133,661)
Nonoperating revenue:			
General appropriations from the State of Hawaii	73,375,585	81,967,200	98,260,994
Other nonoperating income - Net	1,183,211	421,319	1,380,735
Total nonoperating revenue	74,558,796	82,388,519	99,641,729
Excess of expenses over revenue before capital contributions	(68,903,749)	(29,420,823)	(1,491,932)
Capital contributions	28,184,046	29,628,652	37,944,101
(Decrease) increase in net assets	**$ (40,719,703)**	**$ 207,829**	**$ 36,452,169**

For the years ended June 30, 2012, 2011, and 2010, HHSC's operating expenses exceeded its operating revenues by $143.5 million, $111.8 million, and $101.1 million, respectively. General appropriations from the State of Hawaii totaled $73.4 million, $82.0 million, and $98.3 million, respectively. In addition, the appropriations from the State of Hawaii for capital contributions totaled $28.2 million, $29.6 million, and $37.9 million, respectively. These items, along with the other nonoperating revenue, contributed to a decrease in net assets of $40.7 million in 2012, and an increase in net assets in of $208,000 and $36.5 million in 2011 and 2010, respectively.

Operating expenses for the fiscal year ended June 30, 2012 were approximately 11.3 percent higher than 2011. Operating expenses for the fiscal year ended June 30, 2012 increased $67.9 million from fiscal year 2011, which was primarily due to increases in payroll expenses of $41.8 million and nonpayroll expenses of $26.2 million. The increase in payroll expenses is the result of the increase of $14.1 million in the postemployment health care and life insurance benefit liability as well as the reinstatement of the wage concessions made under bargaining unit contracts. The increase in nonpayroll expenses is due primarily to increases at Hilo Medical Center (HMC) of $11.3 million and at Maui Memorial Medical Center (MMMC) of $7.7 million. At HMC, the increase was due to increases of $4.0 million in purchased services and professional fees due to the increased usage of registry nurses to fill vacant positions and for on-call pay to physicians and $3.0 million in medical supplies and drugs due to the increase in volume. At MMMC, the increase was primarily due to other operating expenses of $2.9 million and the increase of $2.8 million in medical supplies and drugs, and was mainly the result of the cardiovascular program commencing in 2012.

Operating expenses for the fiscal year ended June 30, 2011 were approximately 4.9 percent higher than 2010. Operating expenses for the fiscal year ended June 30, 2011 increased $27.9 million from fiscal year 2010 due primarily to increases in nonpayroll expenses of $19.4 million, and to salaries and benefits of $8.5 million. The increase in operating expenses was due primarily to the increases of $14.7 million at MMMC and $10.9 million at HMC. At MMMC, nonpayroll and payroll expenses increased by $7.8 million and $6.9 million, respectively, and were primarily due to the continued expansion of its cardiovascular program services. At HMC, nonpayroll and payroll expenses increased by $7.1 million and $3.8 million, and was due primarily to the increase in volume in all areas, most notably the increase in emergency room visits of 3.9 percent.

Operating expenses for the fiscal year ended June 30, 2010 were approximately 1.2 percent more than the previous year. Operating expenses for the fiscal year ended June 30, 2010 increased $7 million from fiscal year 2009 due primarily to increases in nonpayroll expenses of $10 million offset by a decrease in salaries and benefits expense of $3 million. The increase in nonpayroll expenses was due primarily to a $5.5 million increase at MMMC due to the expansion of its cardiovascular program services during fiscal year 2010 and a $2 million increase at Yukio Okutsu Veterans Care Home due to increased patient volume. The decrease in salaries and benefits expense was due primarily to approximately $14 million in expense reductions from negotiated pay cuts and furloughs for HHSC's employees offset by an increase of approximately $4 million in other postretirement benefits expense allocated to HHSC by the State of Hawaii and increased payroll expenses for the expansion of the cardiovascular program at MMMC and the increased patient volume at Yukio Okutsu Veterans Care home.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both fiscal years 2012 and 2011, as well as the cumulative net losses, is due to several factors which are outlined below.

When the State of Hawaii implemented the QUEST program in 1994, the federal funds provided to the State of Hawaii for Medicaid Disproportionate Share Hospital (DSH) payments to hospitals were used to partially fund the QUEST program in order to expand health insurance coverage to more residents of the state. DSH payments are additional reimbursements that attempt to reflect additional costs incurred by providers who serve a significantly disproportionate number of low-income patients and/or significant number of Medicaid patients. HHSC's patient mix is such that it would have qualified for Medicaid DSH payments had the State of Hawaii not eliminated such payments. Such additional reimbursements would have reduced the amount of State subsidies needed to finance the operations of HHSC. Management estimates that if the State of Hawaii had maintained Medicaid DSH payments, the amount of federal funds received by the State of Hawaii for the Medicaid program would be significantly more than what is currently being provided. To illustrate the importance of Medicaid DSH payments to public hospital systems, the National Association of Public Hospitals' "America's Safety Net Hospitals and Health Systems, 2010" published in June 2012 states that "Medicaid disproportionate share hospital (DSH) funding represented 8 percent of total revenue and financed 24 percent of the unreimbursed care provided by NAPH members in 2010. Additional federal, state, and local payments financed 30 percent of unreimbursed care." The State Department of Human Services (DHS), in partnership with HHSC management, the governor, the State of Hawaii Legislature, and the Healthcare Association of Hawaii (HAH), was able to use HHSC's fiscal years 2012 and 2011 projected losses from providing uncompensated care under the Medicaid fee-for-service program to draw down additional federal funding for all Hawaii hospitals. DHS has paid to HHSC $6.9 million for both fiscal years 2012 and 2011. Because of this innovative approach to drawing down additional federal funds, HHSC was able to reduce its request for State General Fund appropriations by those amounts in fiscal years 2012 and 2011. In the 2009 Legislative Session, the State of Hawaii Legislature appropriated $5.7 million in both fiscal years 2012 and 2011 to DHS in order to provide state matching funds to be used to draw down additional federal funds to be paid specifically to HHSC through the QUEST and QUEST Expanded Access plans. This payment mechanism provided $14.5 million to HHSC in fiscal year 2011 and $11.6 million to HHSC in fiscal year 2012. During the 2012 Legislative Session, management worked with DHS, HAH, the Hawaii Long-term Care Association, and certain key legislators to pass a nursing home and a hospital sustainability fee bill, which was effective on July 1, 2012. The bills allow the State to impose a fee on hospital and nursing home revenues in order to draw down federal funds from the federal Medicaid program to provide additional funding to private hospitals and nursing homes. The bills established that HHSC would be able to utilize more of its compensated care losses to draw down federal funds for its own use. Management estimates that HHSC would receive approximately $15 million more in supplemental payments starting in fiscal year 2013 than what HHSC received in fiscal year 2012. Management will continue to work with DHS, the State of Hawaii Legislature, and HAH to explore other long-term reimbursement enhancements that could reduce HHSC's reliance on General Fund appropriations.

HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2012, HHSC's long-term care occupancy percentage was 88 percent, and there are very few other freestanding long-term care facilities on the neighbor islands. As a result, HHSC's acute care facilities, especially HMC and MMMC, have numerous patients initially admitted as acute patients, but who continue to occupy acute-care beds while awaiting long-term care beds to become available. Such patients are called "wait-list" patients. HHSC receives little to no reimbursement from insurers for such patients, as insurers will not reimburse providers for patients whose required level of care does not coincide with the type of bed the patient is occupying. Medicare does not pay any additional money to hospitals for the additional days spent by the patient in the hospital while the patient waits for a long-term care placement. Medicaid pays approximately 20-30 percent of the cost of those additional wait-listed days to Hawaii hospitals. The 2009 Healthcare Association of Hawaii Wait-list Task Force report shows that the net loss per day for wait-listed patients ranges from $724 to $1,087 per day. Combined, HMC and MMMC have an average census of approximately 45-55 waitlist patients per day. Management expects the wait-list problem to worsen as Hawaii's population continues to age and the State of Hawaii lags behind on a credible plan to address the long-term care crisis.

HHSC's salaries and benefits expenses represent approximately 63 percent of its total operating expenses, and management continues to face several challenging issues regarding management of personnel and personnel costs. HHSC is bound by the collective bargaining agreements negotiated by the State of Hawaii and the public employee unions (HGEA and UPW). The collective bargaining agreements not only bind HHSC to the negotiated pay raises, but also to the union work regulations and benefit packages. Management believes that such arrangements do not allow HHSC to manage its resources as effectively as other healthcare systems.

Also, since the majority of HHSC's facilities are in rural locations, management faces many recruitment and retention issues of key clinical personnel. Areas of acute shortage include anesthetists, imaging technicians, physicians, surgery technicians, pharmacists and pharmacy technicians, and health information management specialists. These shortage areas are caused by several factors: (1) a nation-wide shortage of health care workers, (2) the inability of local colleges and universities to provide sufficient classes and teachers that can educate students in these areas, and (3) competition for these same types of positions with private hospitals, which can pay significantly higher wage rates than HHSC. Another issue compounding HHSC's staffing costs situation is the fact that the vast majority of HHSC's nurses are full-time salaried employees, while the nurses at the other private hospitals are hourly employees. This allows the private hospitals to increase or decrease their nurse staffing based on census; by contrast, HHSC facilities have great difficulty in decreasing their nurse staffing if census is lower than budgeted.

The shortage of physicians on the neighbor islands has been of particular concern to management. In past years, HHSC's facilities had very little contractual or employment relationships with physicians. The medical staff of HHSC's facilities consisted of those physicians with their own practices who had admitting privileges at the facilities. Within the past several years, many of the physicians who had practices on the neighbor islands have left their communities because of a confluence of factors including low physician reimbursements from third-party payors, high malpractice insurance costs, Hawaii's high cost of living, and the lack of tort reform that would limit the amounts that parties could sue medical care providers. As a result, residents of the neighbor islands were at times not able to receive specialty physician services in the event of an emergency, and had to be transported to Oahu to receive the necessary care. As an example, according to Hawaii Health Information Corporation data for fiscal year 2012, approximately 76 percent of Hawaii County residents were discharged for orthopedic surgeries from Oahu hospitals, and approximately 73 percent of Hawaii County residents were discharged for cardiovascular surgeries from Oahu hospitals. In keeping with HHSC's mission of providing and enhancing accessible, comprehensive healthcare services that are quality-driven, customer-focused, and cost-effective, management began to contract or employ physicians to ensure that neighbor island residents would be able to receive quality healthcare in a timely manner in the community in which they reside. HHSC's costs of contracting with or employing physicians increased from $7.8 million in fiscal year 2006 to $21.5 million in fiscal year 2012. These costs not only include the salary or contract payments to the physicians, but also the cost of establishing the clinics and physician offices for those physicians. Management believes that without significant medical tort reform and an increase in physician reimbursement rates, there will be continuing pressure put on HHSC's facilities to recruit and employ the physician specialists that are needed to ensure that neighbor island residents receive the quality healthcare that they deserve.

Related to the physician shortage issue is the issue of on-call coverage. In the past, physicians provided on-call coverage for hospital emergency rooms as part of their duties as a medical staff member. However, due to the financial pressures listed in the paragraph above, physicians have started to demand payment for providing on-call coverage for hospital emergency rooms in order to make up for the financial shortfalls they experience from their private practices. Management has attempted to mitigate the need to pay physicians for on-call coverage by contracting with or employing hospitalists. Hospitalists are doctors whose primary professional focus is the practice of hospital medicine. They help manage patients throughout the continuum of hospital care, often seeing patients in the emergency room, and admitting them to inpatient wards. However, the lack of specialty physician availability on the neighbor islands described above has caused HHSC to pay certain of its physicians to provide on-call coverage for the emergency room. HHSC's cost for hospitalist/on-call coverage was $11.1 million in fiscal year 2011 and $12.6 million in fiscal year 2012.

HHSC inherited aging facilities upon the formation of the Corporation in 1996. These aging facilities require substantial improvements and maintenance before they can be brought up to par with other healthcare facilities in the state of Hawaii. While the State of Hawaii has provided annual funding for capital improvement projects, that funding has been primarily used to correct life-safety code concerns. Funding for medical equipment, application systems, and routine repair and maintenance must be funded from HHSC's operational cash flow. Given HHSC's payor mix and cost burdens, HHSC's operational cash flows are inadequate to fully fund the capital acquisitions that are necessary to keep up with the advances in healthcare technology that allow hospitals to improve the quality of care for their patients. As a result, HHSC's average age of plant in fiscal year 2012 and 2011 was 10.9 years and 11.7 years, respectively, whereas the median average age of plant for all U.S. nonprofit hospitals and health systems is 10.4 years. Management has identified over $900 million in capital improvement projects that need to be funded in the next 10 years in order to have HHSC's facilities continue to deliver quality care to its patients.

Finally, HHSC is a significant provider of health care for the state of Hawaii. For fiscal year 2012, HHSC's facilities accounted for approximately 19 percent of all acute-care discharges and approximately 27 percent of all emergency room visits in the state of Hawaii. HHSC's facilities discharged more acute care patients during that time period than most of the acute care hospitals on Oahu. Also, HHSC is the sole source of hospital services for several isolated neighbor island communities (e.g., Ka'u, Kohala, Lanai, etc.). Further, MMMC is the primary acute care facility on the island of Maui, and HMC and Kona Community Hospital are the only acute care facilities with more than 50 acute-beds on the island of Hawaii. In large part because of HHSC's facilities in Maui, approximately 80 percent of Maui County residents received their care in Maui instead of having to fly to Oahu to receive care. The same can be said for residents of the County of Hawaii, as approximately 66 percent of all residents in the county of Hawaii received medical services from HHSC's five facilities on the island of Hawaii. Also, HHSC's long-term care facilities provide the primary source of long-term care services for elderly people who cannot afford private care or nursing homes and do not have family that can care for them. Given all of the above, management believes that HHSC has a vital role in ensuring that the people of the state of Hawaii have access to quality health care.

HHSC believes that there are two significant challenges facing HHSC in the near future: (1) the impact of federal healthcare reform on HHSC's facilities and (2) the implementation of an electronic medical record/health information system. The Patient Protection and Affordable Health Care Act (PPACA) was signed into law on March 23, 2010. On March 30, 2010, the president enacted the Health Care and Education Reconciliation Act, which made a number of changes to the PPACA. Significant provisions of the PPACA include the following:

- Reduces Medicaid DSH spending by $14 billion over 10 years (2010-2019), and reduces Medicaid DSH spending by $4 billion in 2020. The PPACA originally called for only a temporary allotment of DSH funds to Hawaii. In March 2010, the Health Care and Education Reconciliation Act changed the allotment of DSH funds to Hawaii to permanent status.

- Reduces Medicare DSH payments by $22 billion over 10 years.

- Establishes and authorizes funding for community-based collaborative care networks, which are defined as a consortia of providers with a joint governance structure that provide a comprehensive range of coordinated and integrated healthcare services for low-income patient populations. Each network must include a safety net hospital that serves a high volume of low-income patients and all FQHCs within the network's geographic area, unless such providers do not exist, refuse to participate, or place unreasonable demands on such participation.

- Provides grants to establish community health teams to support a medical home model. States or state-designated entities will be eligible to receive grants to establish community-based multi-disciplinary, interprofessional teams that will establish contractual relationships with primary care providers to provide support services, support medical homes, and improve quality and coordination of care.

- By January 1, 2012, requires the secretary to establish a shared savings program, under which qualifying groups of providers, including hospitals, would be recognized as Medicare Accountable Care Organizations (ACOs) and would share in Medicare cost savings above a certain threshold. The secretary may pay ACOs using a partial capitation model or other payment models that improve quality and efficiency and may give preference to ACOs participating in similar payment arrangements with other payors.

- Beginning October 1, 2012, reduces hospital payments to account for preventable readmissions for a limited number of high-volume or high-expenditure conditions to be selected by the secretary of HHSC. Payment reductions will apply to all admissions. Hospitals' readmission rates will be publicly available on the CMS Hospital Compare website.

- Implements a budget-neutral value-based purchasing program for hospitals, under which Medicare IPPS payments will be reduced by 1 percent in fiscal year FY 2013, 1.25 percent in FY 2014, 1.5 percent in FY 2015, 1.75 percent in FY 2016, and 2 percent in FY 2017 and thereafter to fund incentive payments to hospitals achieving certain quality-based performance scores.

- Adjusts downward the annual market basket increase for inpatient and outpatient hospital services to account for economy-wide productivity gains, beginning in 2012. Productivity adjustments may result in negative market basket changes and a reduction in payment rates from the preceding fiscal year.

- Expands 340B program eligibility (for outpatient drugs) to children's hospitals, critical access hospitals, and rural referral centers with DSH adjustments greater than 8 percent.

- Limits the amount that can be charged by a charitable hospital for emergency or medically necessary care to "the amount generally billed" to individuals who have insurance.

Management estimates that the total impact of the provisions of the PPACA on HHSC's facilities will be a $56,002,000 decrease in reimbursements over a 10-year period (federal fiscal years 2010-2019).

This calculation does not include the impact of potential adjustments for low-volume hospitals, value-based purchasing, healthcare acquired conditions payment penalties, and a cap on outlier payments for home health services. It also does not include the impact on cost-based Medicare plans, such as HMSA 65C+. The largest impact will be on HHSC's acute-care facilities (Hilo, Maui, and Kona), primarily due to the PPACA marketbasket reductions. HHSC's acute-care facilities are not affected by the Medicare DSH reductions because they receive a higher facility-specific Medicare reimbursement rate due to their designation as sole community hospitals. HHSC's critical access hospitals are not significantly affected by the PPACA because those facilities' Medicare reimbursements are cost-based. Management is in the process of evaluating what the impact the Centers for Medicare and Medicaid Services' rule on accountable care organizations or the formation of state health insurance exchanges will have on HHSC.

In July 2011, HHSC entered into a $28.7 million contract with Siemens Healthcare to implement its Soarian Electronic Medical Records (EMR) and Health Information Systems. The system will be implemented in a phased approach, with the first facility going live in November 2012, with subsequent facilities going live through the end of September 2013. Management believes that the installation of an EMR system is a key step in the creation of an integrated health network with real-time access to patient information across the system. Unleashing new efficiencies and capturing quality improvement are examples of the many opportunities that will be enabled through the utilization of contemporary information technology. Driving-out manual intervention, modernizing workflow across the HHSC continuum of care, hard-wiring change, and proactively monitoring performance through near real-time analytics are just a few of the essential elements sought by HHSC in pursuit of Meaningful Use as designated by the Centers for Medicare and Medicaid Services.

Contacting the Corporation's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the Corporation's finances and to show the Corporation's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Corporation's Corporate Office at Hawaii Health Systems Corporation, 3675 Kilauea Avenue, Honolulu, HI 96816.

Hawaii Health Systems Corporation

Balance Sheet

	June 30, 2012	June 30, 2011
Assets		
Current Assets		
Cash and cash equivalents - State of Hawaii (Note 2)	$ 8,484,953	$ 14,189,042
Cash and cash equivalents	29,139,752	41,800,854
Patient accounts receivable - Less allowances for doubtful accounts of $40,128,953 and $33,957,798 for the years ended June 30, 2012 and 2011, respectively (Note 2)	90,019,123	70,893,930
Investments (Note 3)	7,212,156	7,036,342
Supplies and other current assets	19,017,528	17,848,231
Due from the State of Hawaii (Note 5)	60,129,055	57,542,000
Estimated third-party payor settlements	12,344,277	7,255,477
Total current assets	226,346,844	216,565,876
Capital Assets - Net (Note 4)	309,561,477	291,103,090
Assets Limited as to Use (Note 2)	10,335,254	1,870,627
Other Assets	1,676,499	2,708,674
Total assets	**$ 547,920,074**	**$ 512,248,267**
Liabilities and Net Assets (Deficit)		
Current Liabilities		
Current portion of long-term debt (Note 8)	$ 9,212,308	$ 9,246,099
Current portion of capital lease obligations (Note 8)	7,257,210	7,811,490
Accounts payable and accrued expenses	88,925,727	72,071,249
Current portion of accrued workers' compensation (Note 9)	3,058,000	3,311,000
Current portion of accrued vacation (Note 6)	16,036,158	15,603,762
Current portion due to the State of Hawaii (Note 5)	2,000,000	2,500,000
Other current liabilities	1,152,495	2,044,393
Total current liabilities	127,641,898	112,587,993
Long-term Debt - Less current portion (Note 8)	25,352,367	26,523,205
Capital Lease Obligation - Less current portion (Note 8)	24,929,020	17,432,960
Other Liabilities		
Accrued vacation - Less current portion (Note 6)	28,779,340	26,524,413
Accrued workers' compensation - Less current portion (Note 9)	11,836,000	11,898,000
Other postemployment benefit liability (Note 7)	196,718,378	143,024,739
Due to the State of Hawaii (Note 5)	42,122,507	41,622,507
Patients' safekeeping deposits	278,511	468,048
Other liabilities	1,918,459	3,103,105
Total liabilities	459,576,480	383,184,970
Net Assets (Deficit)		
Invested in capital assets - Net of related debt	250,810,573	238,189,336
Restricted for capital purchases (Note 2)	663,192	902,579
Unrestricted	(163,130,171)	(110,028,618)
Total net assets	88,343,594	129,063,297
Total liabilities and net assets	**$ 547,920,074**	**$ 512,248,267**

Hawaii Health Systems Corporation

Statement of Revenue, Expenses, and Changes in Net Assets

	Year Ended June 30, 2012	Year Ended June 30, 2011
Operating Revenue		
Net patient service revenue (net of provision for doubtful accounts of $30,038,943 and $34,293,871 for the years ended June 30, 2012 and 2011, respectively)	$ 513,267,301	$ 479,377,019
Other revenue	11,407,414	9,005,301
Total operating revenue	524,674,715	488,382,320
Operating Expenses		
Salaries and benefits	419,534,023	377,762,380
Purchased services	66,478,625	54,653,979
Medical supplies and drugs	70,171,139	64,202,837
Depreciation and amortization	27,261,446	24,118,505
Utilities	16,809,996	14,514,132
Repairs and maintenance	12,866,757	10,858,978
Other supplies	18,394,512	17,198,328
Professional fees	14,711,491	14,402,765
Insurance	5,465,887	6,316,661
Rent and lease	7,737,477	7,488,707
Other	8,705,907	8,674,390
Total operating expenses	668,137,260	600,191,662
Operating Loss	(143,462,545)	(111,809,342)
Nonoperating Revenue (Expenses)		
General appropriations from the State of Hawaii	73,375,585	81,967,200
Loss on disposal of capital assets	(535,955)	(464,715)
Restricted contributions	1,614,031	1,666,716
Interest expense	(3,693,432)	(4,164,772)
Interest and dividend income	310,390	449,707
Other nonoperating revenue - Net	3,488,177	2,934,383
Total nonoperating revenue	74,558,796	82,388,519
Excess of Expenses Over Revenue Before Capital Contributions	(68,903,749)	(29,420,823)
Capital Contributions	28,184,046	29,628,652
(Decrease) Increase in Net Assets	(40,719,703)	207,829
Net Assets - Beginning of year	129,063,297	128,855,468
Net Assets - End of year	**$ 88,343,594**	**$ 129,063,297**

See Notes to Financial Statements.

Statement of Cash Flows

	Year Ended June 30, 2012	Year Ended June 30, 2011
Cash Flows from Operating Activities		
Cash received from government, patients, and third-party payors	$ 489,053,308	$ 485,903,172
Cash payments to employees for services	(359,818,579)	(334,939,053)
Cash payments to suppliers for services and goods	(210,568,326)	(204,894,256)
Other receipts from operations	11,407,414	9,005,301
Net cash used in operating activities	(69,926,183)	(44,924,836)
Cash Flows from Noncapital Financing Activities		
Appropriations from the State of Hawaii	73,375,585	81,967,200
Other nonoperating revenue - Net	5,102,208	5,903,252
Net cash provided by noncapital financing activities	78,477,793	87,870,452
Cash Flows from Capital and Related Financing Activities		
Purchase of capital assets	(4,819,807)	(14,657,602)
Interest paid	(3,693,432)	(4,164,772)
Issuance of long-term debt	-	100,000
Repayments on long-term debt	(1,204,629)	(4,539,875)
Repayments on capital lease obligations	(9,135,902)	(9,584,639)
Proceeds from sale of assets	267,020	-
Net cash used in capital and related financing activities	(18,586,750)	(32,846,888)
Cash Flows from Investing Activities		
Interest income	310,390	449,707
Increase in short-term investments and assets limited as to use	(8,640,441)	(6,835,951)
Net cash used in investing activities	(8,330,051)	(6,386,244)
Net (Decrease) Increase in Cash and Cash Equivalents	(18,365,191)	3,712,484
Cash and Cash Equivalents - Beginning of year	55,989,896	52,277,412
Cash and Cash Equivalents - End of year	**$ 37,624,705**	**$ 55,989,896**
Balance Sheet Classification of Cash and Cash Equivalents		
Cash and cash equivalents - State of Hawaii	$ 8,484,953	$ 14,189,042
Cash and cash equivalents	29,139,752	41,800,854
Total cash and cash equivalents	**$ 37,624,705**	**$ 55,989,896**

A reconciliation of operating loss to net cash used in operating activities is as follows:

	Year Ended June 30, 2012	Year Ended June 30, 2011
Cash Flows from Operating Activities		
Operating loss	$ (143,462,545)	$ (111,809,342)
Adjustments to reconcile operating loss to net cash from operating activities:		
Provision for doubtful accounts	30,038,943	34,293,871
Depreciation and amortization	27,261,446	24,118,505
Changes in assets and liabilities:		
Patient accounts receivable	(49,164,136)	(33,702,792)
Supplies and other assets	(165,450)	(3,488,244)
Accounts payable, accrued expenses, and other liabilities	14,588,396	(1,626,163)
Accrued workers' compensation liability	(315,000)	(523,000)
Postemployment benefit liability	53,693,639	37,819,891
Estimated third-party payor settlements	(5,088,799)	5,935,074
Accrued vacation	2,687,323	4,057,364
Net cash used in operating activities	**$ (69,926,183)**	**$ (44,924,836)**
Noncash Financing and Investing Activities		
Assets acquired under capital leases and debt	$ 16,077,682	$ 507,718
Capital assets contributed by the State of Hawaii and others	25,596,991	13,209,588
Capital assets included in accounts payable	-	1,699,437
Loss on disposal of capital assets	535,955	464,715
Change in due from the State of Hawaii	2,587,055	15,116,912

Note 1 - Organization

Structure - Hawaii Health Systems Corporation (HHSC or the "Corporation") is a public body corporate and politic and an instrumentality and agency of the State of Hawaii (the "State"). HHSC is managed by a chief executive officer under the control of a 13-member board of directors.

In June 1996, the legislature of the State passed Act 262, S.B. 2522. The act, which became effective in fiscal year 1997, transferred all facilities under the administration of the Department of Health - Division of Community Hospitals to HHSC. HHSC currently operates the following facilities:

East Hawaii Region:
- Hilo Medical Center
- Hale Ho'ola Hamakua
- Ka'u Hospital
- Yukio Okutsu Veterans Care Home (Yukio is not included in the East Hawaii Region audited financial statements)

West Hawaii Region:
- Kona Community Hospital
- Kohala Hospital

Maui Region:
- Maui Memorial Medical Center
- Kula Hospital
- Lanai Community Hospital

Kauai Region:
- Kauai Veterans Memorial Hospital
- Samuel Mahelona Memorial Hospital

Oahu Region:
- Leahi Hospital
- Maluhia
- Kahuku Medical Center

Act 262 also amended a previous act to exempt all facilities from the obligation to pay previously allocated central service and departmental administration expenses by the State.

HHSC is considered to be administratively attached to the Department of Health of the State and is a component unit of the State. The accompanying financial statements relate only to HHSC and the facilities, and are not intended to present the financial position, results of operations, or cash flows of the Department of Health.

Negotiations between HHSC and the State relating to the transfer of assets and assumption of liabilities pursuant to Act 262 had not been finalized as of June 30, 2012. Accordingly, the assets, liabilities, and net assets of HHSC reflected in the accompanying statement of revenue, expenses, and changes in net assets may be significantly different from those eventually included in the final settlement.

The financial statements are being presented for HHSC, Hawaii Health Systems Foundation (HHSF), and Alii Community Care, Inc. (Alii). HHSF and Alii are nonprofit organizations of which HHSC is the sole member. The purpose of HHSF is to raise funds and to obtain gifts and grants on behalf of HHSC. The purpose of Alii is to own, manage, and operate assisted-living and other healthcare facilities in the state.

Note 1 - Organization (Continued)

In June 2007, the State Legislature passed Act 290, S.B. 1792. This act, which became effective July 1, 2007, required the establishment of a 7- to 15-member regional system board of directors for each of the five regions of the HHSC system. Each regional board was given custodial control and responsibility for management of the facilities and other assets in their respective regions. This act also restructured the 13-member HHSC board of directors to 15 members, comprised of 10 members appointed by the governor from nominees submitted by legislative leadership, two at-large members at the governor's discretion, two physician members selected by the HHSC board, and the State Director of Health.

Act 290 also exempted the regions from the requirements of the State procurement code and other exemptions from State agency laws, such as tax clearance certificate requirements, the concession law, and the sunshine law.

In 2009, the Legislature passed Act 182, S.B. 1673, effective July 1, 2009, which allowed the individual facilities or regions of HHSC to transition into a new legal entity in any form recognized under the laws of the State of Hawaii, including but not limited to a nonprofit corporation, a for-profit corporation, a municipal facility, a public benefit corporation, or a combination of the above. The act also amended the requirement for maintenance of services to outline a process that must be followed in order for a facility to substantially reduce or eliminate a direct patient care service. Further, the act reconstituted the HHSC board of directors to a 12-member board of directors which includes the five regional chief executive officers, one representative each appointed by the East Hawaii, West Hawaii, Kauai, and Oahu regional boards, two members appointed by the Maui regional board, and the Director of the Department of Health as an ex-officio nonvoting member.

In June 2011, the legislature passed Act 126, S.B. 1300, effective July 1, 2011, which reconstituted the HHSC board of directors to a 13-member board of directors by adding an at-large voting member appointed by the governor of the State of Hawaii and changing the voting status of the Director of the Department of Health from a nonvoting to voting member.

Note 1 - Organization (Continued)

Kahuku Medical Center - In June 2007, the State Legislature passed Act 113, H.B. 843. This act amended Hawaii Revised Statutes 323F to allow for the assimilation of Kahuku Hospital into HHSC in a manner and to an extent that was to be negotiated between Kahuku Hospital and HHSC. The act also specified that none of the liabilities of Kahuku Hospital were to become the liabilities of HHSC, that HHSC could adjust the levels of services provided by Kahuku Hospital, and that the employees of Kahuku Hospital were not to be considered employees of the State. This act appropriated $3,900,000, which was disbursed through the Department of Health of the State, to pay for the cost of acquiring the assets of Kahuku Hospital and to operate the facility. On March 14, 2008, the asset purchase was completed for a purchase price of approximately $2,652,000 in cash, including transaction costs of $197,000 in cash, and the facility is now operating as Kahuku Medical Center. The purchase price was allocated to assets based on their respective estimated fair values at the acquisition date.

Liquidity - During the year ended June 30, 2012, HHSC incurred losses from operations of approximately $143 million and had negative cash flows from operations of $70 million. Overall, days in accounts payable and days in accounts receivable have increased as compared to June 30, 2011 because of efforts related to implementation of an electronic medical records system. Downward pressures on reimbursements were due to federal healthcare reform and budget cuts to the State of Hawaii MedQUEST program. Although improvements continue to be seen by HHSC, management believes maintaining the current levels of service provided by HHSC will require continued funding by the State of Hawaii.

Reclassification - Certain 2011 amounts have been reclassified to conform to the 2012 presentation. Significant reclassifications include reclassifying $7 million to short-term investments that was previously presented as cash and cash equivalents.

Note 2 - Summary of Significant Accounting Policies

Basis of Accounting - HHSC prepares its financial statements using the economic resources measurement focus and the accrual basis of accounting.

HHSC's financial statements are presented in accordance with the pronouncements of the Governmental Accounting Standards Board (GASB) and the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Health Care Organizations*. Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, HHSC has elected not to apply the provisions of relevant pronouncements of the Financial Accounting Standards Board issued after November 30, 1989.

Note 2 - Summary of Significant Accounting Policies (Continued)

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents include short-term investments with original maturities of three months or less. It also includes amounts held in the State Treasury. The State Director of Finance is responsible for the safekeeping of all monies paid into the State Treasury (cash pool). HHSC's portion of this cash pool at June 30, 2012 and 2011 is indicated in the accompanying balance sheet as "cash and cash equivalents on deposit with the State of Hawaii." The Hawaii Revised Statutes authorize the Director of Finance to invest in obligations of, or guaranteed by, the U.S. government, obligations of the State, federally insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with State statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

HHSC has cash in financial institutions that is in excess of available depository insurance coverage. The amount of uninsured and uncollateralized deposits totaled approximately $34,796,000 and $43,416,000 at June 30, 2012 and 2011, respectively. Accordingly, these deposits were exposed to custodial credit risk. Custodial credit risk is the risk that in the event of a financial institution failure, HHSC's deposits might not be returned to it. HHSC believes that due to the dollar amounts of cash deposits and the limits of FDIC insurance, it is impractical to insure all deposits. As a result, HHSC evaluates each financial institution; only those institutions with an acceptable estimated risk level are used as depositories.

Accounts Receivable - Patient accounts receivable are stated at net realizable value amounts. An allowance for uncollectible accounts is established on an aggregate basis by using historical write-off factors applied to unpaid accounts based on aging. Loss rate factors are based on historical loss experience and adjusted for economic conditions and other trends affecting HHSC's ability to collect outstanding amounts. Uncollectible amounts are written off against the allowance for doubtful accounts in the period they are determined to be uncollectible. An allowance for contractual adjustments is based on expected payment rates from payors based on current reimbursement methodologies.

Supplies - Supplies consist principally of medical and other supplies and are recorded at the lower of first-in, first-out cost, or market.

Note 2 - Summary of Significant Accounting Policies (Continued)

Capital Assets - Capital assets assumed from the State at inception are recorded at cost less accumulated depreciation. Other capital assets are recorded at cost or estimated fair market value at the date of donation. Donated buildings, equipment, and land are recognized as revenue when all eligibility requirements have been met, generally at the date of donation. Equipment under capital leases is recorded at the present value of future payments. Buildings, equipment, and improvements are depreciated by the straight-line method using these asset lives:

Building and improvements	5-40 years
Equipment	3-20 years

Gains or losses on the sale of capital assets are reflected in other nonoperating revenue. Normal repairs and maintenance expenses are charged to operations as incurred.

Certain of HHSC's capital improvement projects are managed by the State Department of Accounting and General Services. The related costs for these projects are transferred to HHSC's capital assets accounts and are reflected as revenue below the nonoperating revenue category in the statement of revenue, expenses, and changes in net assets.

Assets Limited as to Use - Assets limited as to use are restricted net assets, patients' safekeeping deposits, restricted deferred contributions, restricted cash, and cash in escrow account related to future lease draws. Such restrictions have been externally imposed by contributors or by collateral agreements. Restricted resources are applied before unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available. Patients' safekeeping deposits represent funds received or property belonging to the patients that are held by HHSC in a fiduciary capacity as custodian. Receipts and disbursements of these funds are not reflected in HHSC's operations.

At June 30, 2012 and 2011, assets limited as to use consisted of restricted cash of $10,335,254 and $1,870,627, respectively.

Accrued Vacation and Compensatory Pay - HHSC accrues all vacation and compensatory pay at current salary rates, including additional amounts for certain salary-related expenses associated with the payment of compensated absences (such as employer payroll taxes and fringe benefits), in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. Vacation is earned at a rate of one and three-quarters working days for each month of service. Vacation days may be accumulated to a maximum of 90 days.

Postemployment Benefits - HHSC records an expense for postemployment benefits expense, such as retiree medical and dental costs, over the years of service on an accrual basis based on an allocation from the State of Hawaii primarily based on payroll.

Note 2 - Summary of Significant Accounting Policies (Continued)

Net Assets - Net assets are classified in three components. Net assets invested in capital assets - net of related debt consist of capital assets net of accumulated depreciation and are reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. Restricted expendable net assets are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Corporation. Unrestricted net assets are the remaining net assets that do not meet the definition of invested in capital assets - net of related debt or restricted.

Operating Revenue and Expenses - HHSC has defined its operating revenue and expenses as those relating to the provision of healthcare services. The revenue and expenses relating to capital and related financing activities, noncapital financing activities, and investing activities are excluded from that definition.

Net Patient Service Revenue - Net patient service revenue is recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments and provision for doubtful accounts. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care for the years ended June 30, 2012 and 2011 was approximately $4,350,000 and $4,800,000, respectively.

HHSC has agreements with third-party payors that provide for payments at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are recorded on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. The adjustments to the final settlements did not have a significant impact on the fiscal year 2012 and 2011 financial statements.

The estimated third-party payor settlements are based on estimates because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best effort, judgment, and certain methodologies to estimate the anticipated final outcome.

A summary of the payment arrangements with major third-party payors is as follows:

- *Medicare* - Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge referred to as the inpatient prospective payment system (IPPS). Under the IPPS, each case is categorized into a diagnosis-related group (DRG). Each DRG has a payment weight assigned to it, based on the average resources used to treat Medicare patients in that DRG.

Note 2 - Summary of Significant Accounting Policies (Continued)

Outpatient services rendered to Medicare beneficiaries are paid under a prospective payment system called Ambulatory Payment Classifications (APC). Services in each APC are similar clinically and in terms of the resources they require. A payment rate is established for each APC and, depending on the services provided, hospitals may be paid for more than one APC for an encounter.

Skilled nursing services provided to Medicare beneficiaries are paid on a per diem prospective payment system covering all costs (routine, ancillary, and capital) related to the services furnished. The per diem payments for each admission are case-mix adjusted using a resident classification system (resource utilization groups) based on data from resident assessments and relative weights developed from staff time data.

All Medicare-certified hospitals and skilled nursing facilities are required to file annual Medicare cost reports. HHSC facilities required to file Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal year 2007.

- *Medicaid* - Inpatient acute services rendered to Medicaid program beneficiaries are reimbursed under a prospectively determined rate per day and per discharge with a cost settlement for capital costs. Medicaid long-term care services are reimbursed based on a price-based case mix reimbursement system. The case mix reimbursement system uses the resource utilization groups classification system calculated from the minimum data set assessment. The case mix reimbursement payment method takes into account a patient's clinical condition and the resources needed to provide care for the patient. Medicaid outpatient services are reimbursed based on a fee schedule using current procedure terminology (CPT) codes established for the State.

Note 2 - Summary of Significant Accounting Policies (Continued)

- *Critical Access Hospital (CAH)* - HHSC has eight facilities (Hale Ho'ola Hamakua, Kauai Veterans Memorial Hospital, Kahuku Medical Center, Ka'u Hospital, Kohala Hospital, Kula Hospital, Lanai Community Hospital, and Samuel Mahelona Memorial Hospital) that are designated as critical access hospitals (CAH) by the Centers for Medicare and Medicaid Services (CMS). CAHs are limited-service hospitals located in rural areas that receive cost-based reimbursement. To be designated a CAH, a facility must, among other requirements: (1) be located in a county or equivalent unit of a local government in a rural area, (2) be located more than a 35-mile drive from a hospital or another healthcare facility, or (3) be certified by the State as being a necessary provider of healthcare services to residents in the area. These facilities are paid an interim reimbursement rate throughout the year based on each facility's expected costs per inpatient day or the allowable outpatient cost-to-charge. After the close of each fiscal year, the facility would receive retrospective settlements for the difference between interim payments received and the total allowable cost as documented in the Medicare cost reports.

- *Sole Community Hospital* - HHSC has three facilities (Hilo Medical Center, Kona Community Hospital, and Maui Memorial Medical Center) that are designated as sole community hospitals by the CMS. Inpatient case rates for services rendered to Medicare beneficiaries are finally determined upon the filing of the annual Medicare cost reports.

- *Hawaii Medical Service Association (HMSA)* - Inpatient services rendered to HMSA subscribers are reimbursed at prospectively determined case rates. The prospectively determined case rates are not subject to retroactive adjustment. In addition, outpatient surgical procedures and emergency room visits are reimbursed at a negotiated case rate. All other outpatient services are reimbursed based on a fee schedule using standard CPT codes.

- *Other Commercial* - HHSC has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established rates, and prospectively determined daily rates.

The Medicare program has initiated a recovery audit contractor (RAC) initiative, whereby claims subsequent to October 1, 2007 may be reviewed by contractors for validity, accuracy, and proper documentation. HHSC has been contacted by the RAC auditors and is currently unable to determine the extent of liability for overpayments, if any.

Note 2 - Summary of Significant Accounting Policies (Continued)

State Appropriations - HHSC recognizes general and capital appropriations at the time allotments are made available to the facility for expenditure.

Effective July 1, 2008, HHSC - Corporate (Corporate) permanently allocated general appropriations to each facility. General appropriations are reflected as nonoperating revenue and capital appropriations are included in capital grants and contributions after the nonoperating revenue (expenses) subtotal in the statement of revenue, expenses, and changes in net assets. If restrictions are placed on such appropriations, the restrictions are given separate and discrete accounting recognition.

Bond Interest - HHSC is allocated an amount for interest paid by the State of general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is also allocated to HHSC. The bonds are obligations for the State, to be paid by the State's General Fund, and are not reported as liabilities of HHSC. For the years ended June 30, 2012 and 2011, interest expense totaled approximately $6,150,000 and $5,400,000, respectively.

Risk Management - HHSC is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The facilities are self-insured for workers' compensation and disability claims and judgments as discussed in Note 9.

Upcoming Accounting Changes - In November 2010, the GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus*. This pronouncement, which is an amendment to Statement No. 14 and Statement No. 34, modifies certain requirements for inclusion of component units in the financial reporting entity. This statement also amends the criteria for reporting components units as if they were part of the primary government (that is, blending) in certain circumstances. Lastly, the statement also clarifies the reporting of equity interests in legally separate organizations. The statement will be effective for the 2013 fiscal year.

In December 2010, the GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This statement incorporates into GASB literature certain accounting and financial reporting guidance issued on or before November 30, 1989 that is included in FASB statements and interpretations, APB opinions, and accounting research bulletins of the AICPA Committee on Accounting Procedure. The statement will be effective for the 2013 fiscal year.

Note 2 - Summary of Significant Accounting Policies (Continued)

In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The statement incorporates deferred outflows of resources and deferred inflows of resources, as defined by GASB Concepts Statement No. 4, into the definitions of the required components of the residual measure of net position, formerly net assets. This statement also provides a new statement of net position format to report all assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position. Once implemented, this statement will impact the format and reporting of the balance sheet at the government wide level and also at the fund level. The statement will be effective for the 2013 fiscal year.

In March 2012, the GASB issued GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows and inflows of resources, certain items that were previously reported as assets and liabilities. This statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources. The statement will be effective for the 2014 fiscal year.

In June 2012, the GASB issued GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. Statement No. 68 requires governments providing defined benefit pensions to recognize their unfunded pension benefit obligation as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. This net pension liability will be computed differently than the current unfunded actuarial accrued liability, using specific parameters set forth by the GASB. The statement also enhances accountability and transparency through revised note disclosures and required supplemental information (RSI). The statement will be effective for the 2015 fiscal year.

HHSC is currently evaluating the impact these standards will have on the financial statements when adopted.

Note 2 - Summary of Significant Accounting Policies (Continued)

Concentration of Credit Risk - Patient accounts receivable consist of amounts due from insurance companies and patients for services rendered by the facilities. The facilities grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor arrangements. The mix of receivables from patients and third-party payors as of June 30, 2012 and 2011 was as follows:

	Percentage	
	2012	2011
Medicare	24 %	27 %
Medicaid	23	21
HSMA	13	9
Other third-party payors	24	27
Patient and other	16	16
Total	100 %	100 %

Note 3 - Investments

HHSC's investment options are limited to investments listed in the Hawaii Revised Statutes. At June 30, 2012, HHSC held investments in U.S. Treasury obligations, U.S. government agencies, and certificates of deposit. At June 30, 2012, the fair value of these investments were $3,516,834, $1,618,401, and $2,076,921, respectively. At June 30, 2011, HHSC held investments in U.S. Treasury obligations, U.S. government agencies, and certificates of deposit. At June 30, 2011, the fair value of these investments were $3,273,307, $1,736,388, and $2,026,647, respectively.

HHSC's investments are subject to several types of risk, which are examined in more detail below:

Custodial Credit Risk of Investments

Custodial credit risk is the risk that, in the event of the failure of the counterparty, HHSC will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. All of HHSC's investments are held by financial institutions registered in HHSC's name.

Interest Rate Risk

As a means of limiting its exposure to fair value losses arising from interest rates, HHSC's investment policy generally limits maturities on investments to not more than five years from the date of investment. All of HHSC's investments at June 30, 2012 and 2011 have an original maturity date within five years from the date of investment.

Note 3 - Investments (Continued)

Credit Risk

HHSC's investment policy limits investments in state and U.S. Treasury securities, time certificates of deposit, U.S. government or agency obligations, repurchase agreements, commercial paper, bankers' acceptances, and money market funds maintaining a Triple-A rating. As of June 30, 2012 and 2011, HHSC held investments in U.S. Treasury securities and U.S. government agencies.

Concentration of Credit Risk

HHSC's investment policy provides guidelines for portfolio diversification by placing limits on the amount that may be invested in any one issuer, types of investment instruments, and position limits per issue of an investment instrument. There were no investments that individually exceed 5 percent of HHSC's total investments at June 30, 2012 and 2011.

Note 4 - Capital Assets

Transactions in the capital asset accounts for the year ended June 30, 2012 were as follows:

	Beginning of Year	Additions	Retirements	Transfers and Adjustments	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 6,483,834	$ -	$ (27,310)	$ -	$ 6,456,524
Construction in progress	21,485,947	36,215,047	-	(26,298,117)	31,402,877
Assets subject to depreciation:					
Buildings and improvements	376,906,867	2,651,459	(1,976,440)	15,317,115	392,899,001
Equipment	160,299,322	7,627,974	(4,127,442)	10,981,002	174,780,856
Total	565,175,970	46,494,480	(6,131,192)	-	605,539,258
Less accumulated depreciation:					
Buildings and improvements	(154,203,980)	(13,902,785)	1,753,153	(659,798)	(167,013,410)
Equipment	(119,868,900)	(13,330,333)	3,575,064	659,798	(128,964,371)
Total	(274,072,880)	(27,233,118)	5,328,217	-	(295,977,781)
Capital assets - Net	$ 291,103,090	$ 19,261,362	$ (802,975)	$ -	$ 309,561,477

Note 4 - Capital Assets (Continued)

Transactions in the capital assets accounts for the year ended June 30, 2011 were as follows:

	Beginning of Year	Additions	Retirements	Transfers and Adjustments	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 6,483,834	$ -	$ -	$ -	$ 6,483,834
Construction in progress	31,223,642	22,874,321	-	(32,612,016)	21,485,947
Assets subject to depreciation:					
Buildings and improvements	353,427,467	1,677,736	(15,081)	21,816,745	376,906,867
Equipment	148,669,328	5,522,288	(4,687,565)	10,795,271	160,299,322
Total	539,804,271	30,074,345	(4,702,646)	-	565,175,970
Less accumulated depreciation:					
Buildings and improvements	(142,805,679)	(11,563,950)	165,649	-	(154,203,980)
Equipment	(111,413,260)	(12,527,922)	4,072,282	-	(119,868,900)
Total	(254,218,939)	(24,091,872)	4,237,931	-	(274,072,880)
Capital assets - Net	$ 285,585,332	$ 5,982,473	$ (464,715)	$ -	$ 291,103,090

The State Department of Accounting and General Services and others transferred capital assets, including construction in progress, aggregating approximately $25,597,000 and $13,120,000 to HHSC as a contribution of capital for June 30, 2012 and 2011, respectively.

HHSC may enter into capital leases on behalf of the facilities. In that situation, the capital lease obligation is recorded in Corporate's accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records of either Corporate or the facilities. Corporate makes the capital lease payments and incurs the interest expense, while the facilities record depreciation on the capital asset. Corporate also computes capitalized interest on construction in progress and transfers the capitalized interest asset to the facilities. The facilities reimburse Corporate through the due from affiliates account.

The facilities may also enter into capital leases individually. In that situation, the capital lease obligation is recorded in the facility's accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records of the facility. The facility makes the capital lease payments and incurs the interest expense, as well as the depreciation on the capital asset.

In July 2011, HHSC entered into a $28.7 million contract with Siemens Healthcare to implement its Soarian Electronic Medical Records and Health Information Systems. The system will be implemented in a phased approach, with the first facility going live in February 2013, and subsequent facilities going live through the end of September 2013.

Note 5 - State of Hawaii Advances and Receivable

In fiscal year 2003, HHSC received a $14,000,000 advance from the State to relieve its cash flow shortfall. At June 30, 2012 and 2011, HHSC did not have the ability and thus does not intend to repay the advance. Furthermore, management does not expect the State to demand payment of the advance in fiscal year 2013. Accordingly, the advance is classified as a noncurrent liability at June 30, 2012 and 2011. The amount due to the State of $44,122,507 at June 30, 2012 and 2011 includes the $14,000,000 previously described, plus $20,122,507 of cash advances to the Department of Health - Division of Community Hospitals, which was assumed by HHSC at the date of its formation, and $10 million in advances from the State. Of the $10 million in advances, a $2 million advance is due in fiscal year 2013.

At June 30, 2012 and 2011, $60,129,055 and $57,542,000 was due from the State for allotments made to HHSC before June 30, 2012 and 2011, respectively.

Note 6 - Accrued Vacation

Transactions in this account during the year ended June 30, 2012 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 42,128,175	$ 20,024,703	$ (17,337,380)	$ 44,815,498	$ 16,036,158	$ 28,779,340

Transactions in this account during the year ended June 30, 2011 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 38,070,811	$ 20,069,504	$ (16,012,140)	$ 42,128,175	$ 15,603,762	$ 26,524,413

Note 7 - Employee Benefits

Defined Benefit Pension Plans - All full-time employees of HHSC are eligible to participate in the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing, multiple-employer public employee retirement system covering eligible employees of the State and counties.

Note 7 - Employee Benefits (Continued)

The ERS is composed of a contributory retirement plan and a noncontributory retirement plan. Eligible employees who were in service and a member of the existing contributory plan on June 30, 1984 were given an option to remain in the existing plan or join the noncontributory plan effective January 1, 1985. All new eligible employees hired after June 30, 1984 automatically become members of the noncontributory plan. Both plans provide death and disability benefits and cost of living increases. Benefits are established by State statute. In the contributory plan, employees may elect normal retirement at age 55 with five years of credited service or elect early retirement at any age with 25 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 2 percent of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching five years of service; retirement benefits are actuarially reduced for early retirement. Covered contributory plan employees are required by State statute to contribute 7.8 percent of their salary to the plan; HHSC is required by State statute to contribute the remaining amounts necessary to pay contributory plan benefits when due. In the noncontributory plan, employees may elect normal retirement age at 62 with 10 years of credited service or at age 55 with 30 years of credited service, or elect early retirement at age 55 with 20 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 1.25 percent of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching 10 years of service; retirement benefits are actuarially reduced for early retirement. HHSC is required by State statute to contribute all amounts necessary to pay noncontributory plan benefits when due.

On July 1, 2006, a new hybrid contributory plan became effective pursuant to Act 179, Session Laws of Hawaii of 2004. Participants prior to July 1, 2006 could choose to participate in this hybrid plan or remain in the existing plans. New employees hired after July 1, 2006 are required to join the hybrid plan. Participants will contribute 6 percent of their salary to this plan. Further, members in the hybrid plan are eligible for retirement at age 62 with five years of credited service or at age 55 and 30 years of credited service. Members will receive a multiplier of 2 percent for each year of credited service in the hybrid plan. The benefit payment options are similar to the current contributory plan.

HHSC's contribution to the ERS for the years ended June 30, 2012, 2011, and 2010 was approximately $36.7 million, $33.8 million, and $33.6 million, respectively, equal to the required contribution.

The ERS issues a publicly available financial report that includes financial statements and required supplemental information. That report may be obtained by writing to the Employees' Retirement System, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813-2929 or by calling (808) 586-1660.

Note 7 - Employee Benefits (Continued)

Postemployment Health Care and Life Insurance Benefits - In addition to providing pension benefits, the State provides certain postretirement healthcare benefits (medical, prescription drug, vision, and dental) to all qualified employees and their dependents. Pursuant to Act 88 SLH of 2001, the State contributes to the Hawaii employer-union health benefits trust fund, an agent multiple employer defined benefit plan. This plan is sponsored by and administered by the State of Hawaii.

For employees hired before July 1, 1996, the State pays the entire monthly healthcare premium for employees retiring with 10 or more years of credited service, and 50 percent of the monthly premium for employees retiring with fewer than 10 years of credited service. Retirees in this category can elect a family plan to cover dependents.

For employees hired after June 30, 1996 but before July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50 percent of the retired employees' monthly Medicare or non-Medicare premium. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75 percent of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100 percent of the base monthly contribution. Only single plan coverage is provided for retirees in this category. Retirees in this category can elect a family plan to cover dependents.

For employees hired on or after July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50 percent of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75 percent of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100 percent of the base monthly contribution. Only single plan coverage is provided for retirees in this category. Retirees can elect family coverage but must pay the difference in plan costs.

Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive reimbursement of the basic medical coverage premium.

The State of Hawaii receives an annual actuarial valuation to compute the annual required contribution (ARC) necessary to fund the postretirement obligation for all state employees, including those employed by HHSC. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the current normal cost of benefits provided this year and to amortize any unfunded actuarial liabilities over a period not to exceed 30 years. Currently, the State contributes to the plan on a "pay-as-you-go basis," only contributing the amounts necessary to pay for current year benefits.

Note 7 - Employee Benefits (Continued)

For cost allocation purposes, the State allocates the full accrual ARC expense among its component units, including HHSC, based on respective percentages of covered payroll. The State requires HHSC to contribute to the plan at a rate of covered payroll necessary to fund its share of the annual "pay-as-you-go contributions," which is significantly less than the actuarially determined contribution rate. HHSC then allocates its full accrual ARC expense among its various regions based on their respective percentages of covered payroll. The cumulative difference between the amounts the State requires HHSC to contribute and HHSC's allocation of the total plan ARC expense is recorded as other postretirement benefit liability on the balance sheet of each region. HHSC's actual cash contributions for postretirement benefits approximated $19.8 million, $16.3 million, and $16.3 million for the years ended June 30, 2012, 2011, and 2010, respectively.

	2012	2011
Beginning of year	$ 143,024,739	$ 105,204,848
Required contributions	73,515,244	54,089,618
Actual contributions	(19,821,605)	(16,269,727)
End of year	$ 196,718,378	$ 143,024,739

Sick Leave - Accumulated sick leave as of June 30, 2012 and 2011 was approximately $75,796,000 and $67,724,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for sick pay is recorded in the accompanying financial statements.

Note 8 - Long-term Liabilities

Long-term liability activity for the year ended June 30, 2012 was as follows:

	2011	Current Year Additions	Current Year Reductions	2012	Amounts Due Within One Year
Long-term debt	$ 35,769,304	$ -	$ (1,204,629)	$ 34,564,675	$ 9,212,308
Capital lease obligations	$ 25,244,450	$ 16,077,682	$ (9,135,902)	$ 32,186,230	$ 7,257,210

Long-term liability activity for the year ended June 30, 2011 was as follows:

	2010	Current Year Additions	Current Year Reductions	2011	Amounts Due Within One Year
Long-term debt	$ 40,209,179	$ 100,000	$ (4,539,875)	$ 35,769,304	$ 9,246,099
Capital lease obligations	$ 34,321,371	$ 507,718	$ (9,584,639)	$ 25,244,450	$ 7,811,490

Note 8 - Long-term Liabilities (Continued)

The long-term debt obligations are summarized as follows:

Roselani Place - In September 2007, Alii exercised its option to purchase its 113-unit assisted-living and Alzheimer facility and personal property from the developer/landlord for $16 million. In connection with the purchase, Alii also assumed the land lease on which the facility is situated, and a parking license covering real property adjacent to the facility.

In connection with the purchase agreement, Alii also reached an agreement with the developer/landlord concerning an arbitration award that was rendered in favor of the developer/landlord in January 2006 for $1.9 million. The arbitration decision was on appeal to the Intermediate Court of Appeals of the State of Hawaii. Alii and the developer/landlord agreed to settle the $1.9 million judgment for $500,000. This settlement payment is in addition to the $16 million purchase price.

The note payable requires monthly payments, including interest at 5.9 percent, ranging from $107,241 to $126,433 through October 2027. The note is collateralized by certain property and equipment. At June 30, 2012 and 2011, the balance payable was $15,211,810 and $15,591,132, respectively.

MMMC Working Capital Financing - In April 2008, Maui Memorial Medical Center (MMMC) obtained an $11 million taxable revolving line of credit loan facility from JPMorgan Chase Bank, N.A. for working capital purposes. On May 20, 2010, MMMC signed a revised agreement on the $11 million taxable revolving line of credit, removing financial covenants and restructuring repayment. In January 2011, JPMorgan Chase Bank, N.A. assigned its interest in the taxable revolving line of credit loan facility to Bank of Montreal. MMMC and Bank of Montreal agreed to amend the terms and conditions of the loan to extend the maturity date to September 2012. At June 30, 2012 and 2011, the balance payable was $8,000,000. Subsequent to year end, MMMC secured financing through the USDA for $8,000,000. The proceeds were used to extinguish the the Bank of Montreal loan, and will be used for various additions and renovations at MMMC. Financing costs of approximately $100,000 were also paid out of proceeds.

Note 8 - Long-term Liabilities (Continued)

Hilo Residency Training Program - In June 2001, HHSC acquired land, building, and medical equipment of $11,893,162 from Hilo Residency Training Program, Inc. (HRTP) to ensure the uninterrupted operation of the Hilo Medical Center Cancer Treatment Center and its radiation and medical oncology services. As part of the acquisition, HHSC assumed HRTP's outstanding balances on the loans and notes payable of $11,893,162 from Central Pacific Bank and the United States Department of Agriculture (USDA). The assets and related liabilities have been recorded in the facility's accounting records. The loans and notes payable are collateralized by a security interest in the capital assets acquired from HRTP, as well as any rights, interest, and other tangible assets relating to such property. In October 2007, the loans and notes payable to Central Pacific Bank and the USDA were refinanced into a single note payable to Academic Capital.

The note payable requires monthly payments, including interest, totaling $64,069 through September 2032. The note payable is secured by certain assets of Hilo Medical Center (HMC). At June 30, 2012 and 2011, the balance payable was $9,073,898 and $9,300,073, respectively.

Yukio Okutsu Veterans' Home - In May 2008, the Yukio Okutsu Veterans' Home entered into a line of credit for $1.8 million, which calls for monthly interest-only payments at an interest rate of 5 percent. In December 2012, the Yukio Okutsu Veterans' Home signed an extension, which extended the balloon principal payment due date from December 2012 to December 2013. In addition, the line of credit limit was reduced to $1,400,000. At June 30, 2012 and 2011, the balance payable was $1,139,141 and $1,262,151, respectively.

KVMH's Port Allen Clinic - In April 2008, HHSC - Corporate entered into a promissory note with a bank to finance the leasehold improvements for KVMH's Port Allen clinic. The note requires monthly principal and interest payments of $16,207 through maturity at November 23, 2017. The note is secured by a security interest in the leasehold improvements of the clinic. At June 30, 2012 and 2011, the balance payable was $800,114 and $919,881, respectively.

Maui Memorial Medical Center Nurses' Cottages - During fiscal year 2003, Corporate acquired buildings for $1,690,000 on behalf of MMMC for use in its operations. The loan is payable to a municipal lessor with interest at 6.3 percent, and monthly principal and interest payments of $19,028 through November 2012. During fiscal year 2003, Corporate transferred the buildings to MMMC, but retained the loan payable in its accounting records. The loan payable is collateralized by a security interest in the capital assets acquired. At June 30, 2012 and 2011, the balance payable was $75,124 and $291,354, respectively.

Note 8 - Long-term Liabilities (Continued)

Alii Health Center - During fiscal year 2010, Alii Health Center entered into a note payable. The note payable was used to finance the purchase of billing software. This note requires monthly payments, including interest at 8 percent, ranging from $3,290 to $110,000, through May 2013. This note is collateralized by certain equipment. At June 30, 2012 and 2011, the balance payable was $208,658 and $230,286, respectively.

Kahuku Medical Center - During 2011, Kahuku Medical Center entered into an unsecured loan with a local bank in the amount of $100,000 at an annual interest rate of 7.75 percent. The loan is due on demand, or if no demand, then on or before 30 days from the original loan date. At June 30, 2012 and 2011, the balance of the loan was $55,930 and $100,000, respectively.

The capital lease obligations are summarized as follows:

Corporate - HHSC entered into capital leases on behalf of the facilities. The capital lease obligation is recorded in HHSC - Corporate's accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records of either Corporate or the facilities. Corporate makes the capital lease payments and incurs the interest expense, while the facilities record depreciation on the capital asset. Corporate also computes capitalized interest on construction in progress and transfers the capitalized interest asset to the facilities. The facilities reimburse Corporate through the due from affiliates account. For the years ended June 30, 2012 and 2011, capitalized interest was not material. Capital lease obligations recorded on Corporate's accounting records at June 30, 2012 and 2011 were $30,776,781 and $23,143,417, respectively.

During 2012, Corporate entered into a capital lease with Siemens for the financing of an electronic medical records system that is currently being installed.

Maui Memorial Medical Center - In September 2009, MMMC entered into a capital lease for the acquisition of equipment for $780,000. The lease requires monthly payments over 48 months with a bargain purchase option at the end of the term. On November 30, 2009, MMMC entered into a capital lease for the acquisition of equipment for $830,000. The lease requires monthly payments over 60 months and is collateralized by the equipment. At June 30, 2012 and 2011, the balance payable on these leases was $564,418 and $852,226, respectively.

Hilo Medical Center - In September 2009, Hilo Medical Center entered into a capital lease for wireless communication and related equipment for $499,850. The lease term is 36 months, with a monthly payment of $16,750, including interest at a rate of 12.62 percent. The lease is collateralized by the equipment. At June 30, 2012 and 2011, the balance payable was $65,274 and $245,484, respectively.

Note 8 - Long-term Liabilities (Continued)

Kahuku Medical Center - During fiscal year 2010, Kahuku Medical Center entered into various capital lease obligations. The leases require monthly payments and are collateralized by the equipment. At June 30, 2012 and 2011, the balance payable was $29,406 and $114,799, respectively.

Kauai Veterans Memorial Hospital - In August 2009, KVMH entered into a capital lease for the acquisition of a mammography machine. The lease term is 60 months, with a monthly payment of $12,748, including interest at a rate of 8.5 percent. The lease is collateralized by the equipment. In October 2009, KVMH entered into a capital lease for the acquisition of an MRI machine. The lease term is 60 months, with a monthly payment of $13,676, including interest at a rate of 8.5 percent. The lease is collateralized by the equipment. At June 30, 2012 and 2011, the balance payable on the leases was $638,064 and $888,524, respectively.

The following is a schedule by years of principal and interest as of June 30, 2012:

	Long-term Debt		Capital Lease Obligation	
Years Ending June 30	Principal	Interest	Principal	Interest
2013	$ 9,212,308	$ 1,554,196	$ 7,257,210	$ 1,354,842
2014	2,263,255	1,480,792	8,178,620	829,847
2015	1,136,913	1,343,715	6,296,222	430,991
2016	1,410,339	1,270,467	5,227,379	310,920
2017	1,103,704	4,823,670	2,050,417	228,170
2018-2022	6,607,049	4,823,670	1,905,257	619,232
2023-2027	8,867,690	2,563,030	1,271,125	173,773
2028-2032	3,773,084	576,828	-	-
2033-2036	190,333	1,875	-	-
Total payments	$ 34,564,675	$ 18,438,243	$ 32,186,230	$ 3,947,775

Note 9 - Commitments and Contingencies

Professional Liability - HHSC maintains professional and general liability insurance with a private insurance carrier with a $35 million limit per claim and a $39 million aggregate. HHSC has also purchased additional excess insurance with a $10 million per claim and aggregate limit. HHSC's general counsel advises that, in the unlikely event any judgments rendered against HHSC exceed HHSC's professional liability coverage, such amount would likely be paid from an appropriation from the State's General Fund. Settled claims have not exceeded the coverage provided by the insurance carrier in any of the past three fiscal years.

Note 9 - Commitments and Contingencies (Continued)

Workers' Compensation Liability - HHSC is self-insured for workers' compensation claims. HHSC pays a portion of wages for injured workers (as required by law), medical bills, judgments as stipulated by the State's Department of Labor, and other costs. HHSC also directly provides treatment for injured workers. The estimated liability is based on actuarial projections of costs using historical claims-paid data. Estimates are continually monitored and reviewed and, as settlements are made or estimates adjusted, differences are reflected in current operations. HHSC has accrued a liability of $14,894,000 and $15,209,000 for unpaid claims as of June 30, 2012 and 2011, respectively.

	2012	2011
Estimated liability - Beginning of year	$ 15,209,000	$ 15,732,000
Estimated claims incurred - Including changes in estimates	2,745,000	2,787,200
Claim payments	(3,060,000)	(3,310,200)
Estimated liability - End of year	$ 14,894,000	$ 15,209,000

Operating Leases - HMC, MMMC, and Kahuku entered into various operating leases and related sublease agreements. Future minimum lease payments and sublease receipts at June 30, 2012 are as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2013	$ 1,735,675	$ 106,294
2014	1,726,948	106,294
2015	1,755,152	106,294
2016	1,784,208	106,294
2017	1,814,128	106,294
Thereafter	6,780,024	-
Total	$ 15,596,135	$ 531,470

Ceded Lands - The Office of Hawaiian Affairs (OHA) and the State are presently in litigation involving the State's alleged failure to properly account for and pay to OHA monies due to OHA under the provisions of the Hawaii State Constitution and Chapter 10 of the Hawaii Revised Statutes for use by the State of certain ceded lands.

Note 9 - Commitments and Contingencies (Continued)

During the 2006 Legislative session, the State of Hawaii Legislature enacted Act 178, which provided interim measures to ensure that a certain amount of proceeds was made available to OHA from the pro rata portion of the public land trust, for the betterment of the conditions of native Hawaiians. The act provided that the State agencies that collect receipts from the use of lands within the public land trust transfer a total of $3,775,000 to OHA within 30 days of the close of each fiscal quarter (or $15,100,000 per fiscal year), beginning with the 2006 fiscal year. In addition, the act appropriated $17,500,000 out of the State's general revenue to pay OHA for underpayments of the State's use of lands in the public land trust for the period from July 1, 2001 to June 30, 2005.

On September 20, 2006, the governor of the State of Hawaii issued Executive Order No. 06-06, which established procedures for the State agencies to follow in order to carry out the requirements of Act 178. Each State agency that collects receipts from the use of ceded or public land trust land is to determine OHA's share of such receipts by calculating the ceded/nonceded fraction of the parcel that generated the receipt, multiplying the receipt by the ceded/nonceded fraction, and multiplying that result by 20 percent. The resulting amounts are to be deposited into a trust holding account established for such purpose, and within 10 days of the close of each fiscal quarter, the amounts are to be transferred to OHA. Within a specified period after the close of each quarter, the director of finance is to reconcile the actual amounts transferred to OHA with the required amount of $3,775,000 and adjust each specific agency's payments accordingly.

For the years ended June 30, 2012 and 2011, there were no payments made to OHA.

Litigation - HHSC is a party to certain litigation arising in the normal course of business. In management's opinion, the outcome of such litigation will not have a material impact on HHSC's financial statements.

Note 10 - Clinical Laboratories of Hawaii Partnership

On May 1, 2002, HHSC entered into a partnership agreement with Clinical Laboratories of Hawaii, Inc., St. Francis Healthcare Enterprises, Inc., and Kapiolani Service Corporation to form Clinical Laboratories of Hawaii, LLP (the "Partnership"). The primary purpose of the Partnership was to provide clinical laboratory services within the State of Hawaii. On June 1, 2002, HHSC contributed the use of the laboratory space and related ancillary services in seven of its facilities (Hilo Medical Center, Kona Community Hospital, MMMC, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a less than controlling interest in the Partnership.

Note 10 - Clinical Laboratories of Hawaii Partnership (Continued)

In September 2008, the partners sold their interest in the Partnership to Sonic Healthcare USA. According to the terms of the sale, the majority of the sales proceeds was distributed to each of the partners in the Partnership according to their ownership percentage in the Partnership, with a certain portion being held in escrow to cover unanticipated compliance claims, to be distributed to the partners at certain dates in the future. HHSC's share of the sales proceeds was $8,484,290, which was used to pay down HHSC's accounts payable to the Partnership as stated in the sale agreement. In addition, the terms of the agreement require HHSC to continue to provide laboratory space and certain ancillary services until May 2012. As a result, $4 million of the proceeds was deferred and has been amortized on a straight-line basis through May 2012 for the obligation to provide this space.

Other Supplemental Information

Hawaii Health Systems Corporation

Supplemental Schedule of Reconciliation of Cash on Deposit and Assets Limited as to Use with the State of Hawaii
Year Ended June 30, 2012

	Appropriation Symbol		
Cash and cash equivalents - State of Hawaii			
Special funds:			
	S-98-396-H	$	381,485
	S-93-359-H		2,818
	S-96-359-H		2,007
	S-97-359-H		3,556
	S-93-353-H		6,563
	S-12-350-H		3,650,154
	S-12-351-H		330,426
	S-12-352-H		190,773
	S-12-353-H		187,660
	S-11-354-H		1,576,664
	S-10-335-H		257,498
	S-10-371-H		679,604
	S-10-358-H		3,879
	S-09-365-H		625,277
	S-09-312-H		581,721
Trust funds:	T-04-918-H		1,273
	T-04-921-H		6,679
Total per State			8,488,037
Reconciling items			(3,084)
Total per HHSC		**$**	**8,484,953**
Assets limited as to use - Patient trust funds:			
	T-04-923-H	$	4,129
	T-04-911-H		22,912
	T-11-909-H		10,858
	T-11-925-H		70,701
Total per State			108,600
Reconciling items:			
Patient's safekeeping deposits held by financial institutions			77,832
Restricted assets held by financial institutions			10,148,822
Total per HHSC		**$**	**10,335,254**

Hawaii Health Systems Corporation

Balance Sheet of Facilities
June 30, 2012

	Facilities									
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home - Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital
Assets										
Current Assets										
Cash and cash equivalents - State of Hawaii	$ 3,650,154	$ 331,699	$ 185,525	$ -	$ 1,576,664	$ 194,223	$ 257,498	$ 679,604	$ 3,879	$ 581,721
Cash and cash equivalents	2,167,760	11,349	(49,549)	700	3,385,860	1,377,270	15,655,538	465,888	222,530	388,279
Patient accounts receivable - Less allowances for doubtful accounts	25,722,058	2,817,991	549,218	1,432,762	12,560,352	597,631	27,420,526	3,694,810	555,050	2,284,941
Investments	7,212,156	-	-	-	-	-	-	-	-	-
Supplies and other current assets	3,548,142	131,299	326,896	24,775	2,020,560	56,455	8,647,157	343,364	97,947	655,905
Due from the State of Hawaii	1,561,000	18,000	4,821,000	-	7,336,060	255,995	21,904,000	8,948,000	1,894,000	1,239,000
Estimated third-party payor settlements	3,432,763	201,498	228,772	-	1,832,551	228,204	4,375,906	243,379	102,120	400,305
Total current assets	47,294,033	3,511,836	6,061,862	1,458,237	28,712,047	2,709,778	78,260,625	14,375,045	2,875,526	5,550,151
Due from Affiliates - Net	-	-	-	-	-	-	-	-	-	-
Capital Assets - Net	50,705,343	20,462,263	3,080,487	25,376,282	21,941,698	1,235,137	117,093,973	7,515,390	2,089,737	7,077,120
Assets Limited as to Use	38,443	21,585	4,747	-	547,516	-	41,797	60,920	4,282	94,204
Other Assets	352,203	-	-	1,567	107,547	-	1,107,682	-	-	-
Total assets	**$ 98,390,022**	**$ 23,995,684**	**$ 9,147,096**	**$ 26,836,086**	**$ 51,308,808**	**$ 3,944,915**	**$ 196,504,077**	**$ 21,951,355**	**$ 4,969,545**	**$ 12,721,475**
Liabilities and Net Assets (Deficit)										
Current Liabilities										
Current portion of long-term debt	$ 239,886	$ -	$ -	$ -	$ -	$ -	$ 8,000,000	$ -	$ -	$ -
Current portion of capital lease obligations	65,274	-	-	-	-	-	287,808	-	-	-
Accounts payable and accrued expenses	25,591,341	1,246,339	519,562	669,500	8,985,090	498,566	31,124,164	2,319,663	680,489	2,114,250
Current portion of accrued workers' compensation liability	485,000	93,000	17,000	-	554,000	161,000	754,000	188,000	2,000	460,000
Current portion of accrued vacation	3,844,567	273,340	206,872	14,330	1,797,522	165,514	4,517,792	887,849	90,583	1,074,000
Current portion of due to State of Hawaii	-	-	-	-	-	-	2,000,000	-	-	-
Other current liabilities	204,948	-	120	-	-	-	294,254	1,614	-	-
Total current liabilities	30,431,016	1,612,679	743,554	683,830	11,336,612	825,080	46,978,018	3,397,126	773,072	3,648,250
Long-term Debt - Less current portion	8,834,012	-	-	1,139,141	-	-	-	-	-	-
Capital Lease Obligations - Less current portion	-	-	-	-	-	-	276,610	-	-	-
Other Liabilities										
Accrued vacation - Less current portion	6,648,728	627,880	234,258	-	2,763,612	365,047	7,646,256	1,502,662	153,309	1,905,309
Accrued workers' compensation - Less current portion	2,883,000	243,000	213,000	-	1,234,000	96,000	3,704,000	936,000	79,000	529,000
Other postemployment benefit liability	47,414,666	4,366,202	2,692,592	-	20,422,494	2,365,384	65,597,572	8,847,094	1,277,238	9,580,053
Due to affiliates - Net	76,490,907	996,069	9,931,032	525,461	47,051,724	9,387,048	(37,696)	23,326,227	15,013,938	18,966,109
Due to the State of Hawaii	-	506,153	-	-	7,605,205	528,149	8,000,000	1,114,264	-	6,416,791
Patients' safekeeping deposits	38,443	21,585	4,747	-	-	-	-	60,920	4,282	83,347
Other liabilities	19,663	-	-	1,863,258	6,164	-	-	-	-	-
Total liabilities	172,760,435	8,373,568	13,819,183	4,211,690	90,419,811	13,566,708	132,164,760	39,184,293	17,300,839	41,128,859
Net Assets (Deficit)										
Invested in capital assets - Net of related debt	41,566,171	20,462,263	3,080,487	24,237,141	21,953,752	1,235,137	116,529,555	7,515,389	2,089,738	7,077,120
Restricted for capital purchases	-	-	-	-	547,516	-	41,797	-	-	10,858
Unrestricted	(115,936,584)	(4,840,147)	(7,752,574)	(1,612,745)	(61,612,271)	(10,856,930)	(52,232,035)	(24,748,327)	(14,421,032)	(35,495,362)
Total net assets (deficit)	(74,370,413)	15,622,116	(4,672,087)	22,624,396	(39,111,003)	(9,621,793)	64,339,317	(17,232,938)	(12,331,294)	(28,407,384)
Total liabilities and net assets (deficit)	**$ 98,390,022**	**$ 23,995,684**	**$ 9,147,096**	**$ 26,836,086**	**$ 51,308,808**	**$ 3,944,915**	**$ 196,504,077**	**$ 21,951,355**	**$ 4,969,545**	**$ 12,721,475**

	Facilities												
	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifications and Eliminations	HHSC Consolidated
Assets													
Current Assets													
Cash and cash equivalents - State of Hawaii	$ 625,277	$ -	$ 8,381	$ 8,843	$ 8,103,468	$ 381,485	$ -	$ 8,484,953	$ -	$ -	$ -	$ -	$ 8,484,953
Cash and cash equivalents	620,988	623,945	591,521	1,894	25,463,973	3,362,130	-	28,826,103	50,697	110,720	152,232	-	29,139,752
Patient accounts receivable - Less allowances for doubtful accounts	2,391,585	1,310,758	5,187,778	3,309,038	89,834,498	-	-	89,834,498	-	2,996	181,629	-	90,019,123
Investments	-	-	-	-	7,212,156			7,212,156					7,212,156
Supplies and other current assets	2,020,385	198,835	695,374	150,012	18,917,106	28,916	-	18,946,022	-	38,383	33,123	-	19,017,528
Due from the State of Hawaii	3,499,000	4,979,000	1,037,000	1,140,000	58,632,055	1,497,000	-	60,129,055	-	-	-	-	60,129,055
Estimated third-party payor settlements	221,445	29,186	754,526	293,622	12,344,277	-	-	12,344,277	-	-	-	-	12,344,277
Total current assets	9,378,680	7,141,724	8,274,580	4,903,409	220,507,533	5,269,531	-	225,777,064	50,697	152,099	366,984	-	226,346,844
Due from Affiliates - Net	-	-	-	-	-	319,109,179	(305,433,885)	13,675,294	-	-	-	(13,675,294)	-
Capital Assets - Net	6,205,206	3,130,423	12,585,395	6,578,830	285,077,284	11,678,436	-	296,755,720	-	12,400,608	405,149	-	309,561,477
Assets Limited as to Use	60,463	350	42,386	25,009	941,702	9,393,552	-	10,335,254	-	-	-	-	10,335,254
Other Assets	-	-	60,750	-	1,629,749	-	-	1,629,749	-	-	46,750	-	1,676,499
Total assets	**$ 15,644,349**	**$ 10,272,497**	**$ 20,963,111**	**$ 11,507,248**	**$ 508,156,268**	**$ 345,450,698**	**$ (305,433,885)**	**$ 548,173,081**	**$ 50,697**	**$ 12,552,707**	**$ 818,883**	**$ (13,675,294)**	**$ 547,920,074**
Liabilities and Net Assets (Deficit)													
Current Liabilities													
Current portion of long-term debt	$ -	$ -	$ 131,499	$ -	$ 8,371,385	$ 75,124	$ -	$ 8,446,509	$ -	$ 557,140	$ 208,659	$ -	$ 9,212,308
Current portion of capital lease obligations	-	29,406	273,456	-	655,944	6,578,378	-	7,234,322	-	-	22,888	-	7,257,210
Accounts payable and accrued expenses	1,707,539	1,013,062	4,950,809	1,842,884	83,263,258	4,732,086	-	87,995,344	-	201,723	443,380	285,280	88,925,727
Current portion of accrued workers' compensation liability	117,000	-	113,000	114,000	3,058,000	-	-	3,058,000	-	-	-	-	3,058,000
Current portion of accrued vacation	839,000	220,717	1,246,181	553,824	15,732,091	304,067	-	16,036,158	-	-	-	-	16,036,158
Current portion of due to State of Hawaii	-	-	-	-	2,000,000	-	-	2,000,000	-	-	-	-	2,000,000
Other current liabilities	-	58,655	182,216	30,000	771,807	-	-	771,807	-	380,688	-	-	1,152,495
Total current liabilities	2,663,539	1,321,840	6,897,161	2,540,708	113,852,485	11,689,655	-	125,542,140	-	1,139,551	674,927	285,280	127,641,898
Long-term Debt - Less current portion	-	55,930	668,615	-	10,697,698	-	-	10,697,698	-	14,654,669	-	-	25,352,367
Capital Lease Obligations - Less current portion	-	-	364,608	-	641,218	24,198,403	-	24,839,621	-	-	89,399	-	24,929,020
Other Liabilities													
Accrued vacation - Less current portion	1,398,648	-	2,995,129	1,355,914	27,596,752	1,147,626	-	28,744,378	-	-	34,962	-	28,779,340
Accrued workers' compensation - Less current portion	466,000	-	841,000	419,000	11,643,000	193,000	-	11,836,000	-	-	-	-	11,836,000
Other postemployment benefit liability	8,028,889	-	16,048,396	5,796,067	192,436,647	4,281,731	-	196,718,378	-	-	-	-	196,718,378
Due to affiliates - Net	28,796,040	827,190	57,220,311	16,939,525	305,433,885	-	(305,433,885)	-	-	13,916,529	44,045	(13,960,574)	-
Due to the State of Hawaii	491,450	-	1,043,345	2,417,150	28,122,507	14,000,000	-	42,122,507	-	-	-	-	42,122,507
Patients' safekeeping deposits	35,928	350	4,944	23,965	278,511	-	-	278,511	-	-	-	-	278,511
Other liabilities	-	-	20,931	8,443	1,918,459	-	-	1,918,459	-	-	-	-	1,918,459
Total liabilities	41,880,494	2,205,310	86,104,440	29,500,772	692,621,162	55,510,415	(305,433,885)	442,697,692	-	29,710,749	843,333	(13,675,294)	459,576,480
Net Assets (Deficit)													
Invested in capital assets - Net of related debt	6,205,206	3,045,087	11,147,217	6,578,831	272,723,094	1,228,154	-	273,951,248	-	(2,811,201)	32,016	(20,361,490)	250,810,573
Restricted for capital purchases	24,535	-	37,442	1,044	663,192	-	-	663,192	-	-	-	-	663,192
Unrestricted	(32,465,886)	5,022,100	(76,325,988)	(24,573,399)	(457,851,180)	288,712,129	-	(169,139,051)	50,697	(14,346,841)	(56,466)	20,361,490	(163,130,171)
Total net assets (deficit)	(26,236,145)	8,067,187	(65,141,329)	(17,993,524)	(184,464,894)	289,940,283	-	105,475,389	50,697	(17,158,042)	(24,450)	-	88,343,594
Total liabilities and net assets (deficit)	**$ 15,644,349**	**$ 10,272,497**	**$ 20,963,111**	**$ 11,507,248**	**$ 508,156,268**	**$ 345,450,698**	**$ (305,433,885)**	**$ 548,173,081**	**$ 50,697**	**$ 12,552,707**	**$ 818,883**	**$ (13,675,294)**	**$ 547,920,074**

Statement of Revenue, Expenses, and Changes in Net Assets (Deficit) of Facilities
Year Ended June 30, 2012

	Facilities									
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home - Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital
Operating Revenue										
Net patient service revenue - Net of provision for doubtful accounts	$ 135,458,716	$ 11,022,051	$ 5,288,446	$ 11,771,227	$ 60,019,945	$ 5,375,539	$ 185,160,801	$ 14,389,119	$ 2,720,767	$ 13,814,119
Other revenue	2,801,198	32,460	782,046	-	632,447	14,762	2,071,153	76,649	6,785	301,394
Total operating revenue	138,259,914	11,054,511	6,070,492	11,771,227	60,652,392	5,390,301	187,231,954	14,465,768	2,727,552	14,115,513
Operating Expenses										
Salaries and benefits	98,340,757	9,376,721	5,691,173	5,436,338	42,631,124	5,328,319	134,580,987	18,320,756	2,963,753	19,250,252
Purchased services	19,434,003	2,480,063	910,177	1,504,448	9,448,455	1,200,906	21,640,892	883,036	1,320,411	765,228
Medical supplies and drugs	18,057,320	503,878	165,797	407,554	7,881,680	124,144	37,911,059	695,324	284,215	572,410
Depreciation and amortization	6,598,325	846,416	437,324	1,035,880	3,047,794	365,112	8,890,757	475,350	90,125	939,561
Utilities	3,039,728	685,723	195,096	1,007,786	1,723,164	175,428	4,819,664	393,379	131,730	1,224,916
Repairs and maintenance	3,510,901	245,963	119,010	72,641	1,840,101	303,819	3,879,116	668,239	44,851	320,933
Other supplies	4,665,800	490,868	205,847	498,377	1,324,721	293,340	6,249,437	837,904	134,571	799,163
Professional fees	7,223,759	3,527	57,375	105,167	654,370	127,125	2,185,823	28,085	1,997	33,850
Insurance	1,343,990	62,559	79,822	1,127,367	514,825	29,474	1,148,536	137,100	14,155	108,997
Rent and lease	2,417,851	23,528	27,805	48,894	669,205	47,424	2,984,274	49,526	12,504	33,791
Other	2,608,310	121,652	80,762	1,069,163	724,441	62,965	2,078,940	75,443	62,081	62,162
Total operating expenses	167,240,744	14,840,898	7,970,188	12,313,615	70,459,880	8,058,056	226,369,485	22,564,142	5,060,393	24,111,263
Operating Loss (Income)	(28,980,830)	(3,786,387)	(1,899,696)	(542,388)	(9,807,488)	(2,667,755)	(39,137,531)	(8,098,374)	(2,332,841)	(9,995,750)
Nonoperating Revenue (Expenses)										
General appropriations from the State of Hawaii	15,158,167	1,312,625	1,202,768	-	11,539,307	790,126	23,892,109	1,818,821	1,150,200	4,928,134
Loss on disposal of capital assets	(5,121)	-	-	-	(277,775)	-	(259,721)	-	-	-
Restricted contributions	856,105	-	62,293	-	11,363	7,617	372,376	-	-	-
Interest expense	(563,391)	(3,180)	(56)	(54,759)	(138,505)	-	(222,160)	(2,034)	-	(2,204)
Interest and dividend income	118,639	-	10,055	-	11,527	-	25,809	18,022	84	23,661
Corporate allocation expense	(2,360,137)	(200,895)	(107,614)	-	(1,018,862)	(109,364)	(3,277,923)	(324,830)	(73,827)	(345,109)
Other nonoperating revenue (expenses) - Net	725,562	465,325	7,788	(1,567)	(217,332)	30,513	484,712	127,565	120,012	10,746
Total nonoperating revenue (expenses)	13,929,824	1,573,875	1,175,234	(56,326)	9,909,723	718,892	21,015,202	1,637,544	1,196,469	4,615,228
Excess of Revenue (Under) Over Expenses Before Capital Contributions	(15,051,006)	(2,212,512)	(724,462)	(598,714)	102,235	(1,948,863)	(18,122,329)	(6,460,830)	(1,136,372)	(5,380,522)
Capital Contributions	572,009	(128,625)	(92,623)	-	6,795,906	35,000	(2,643,764)	6,846,730	1,310,289	3,552,549
(Decrease) Increase in Net Assets	**$ (14,478,997)**	**$ (2,341,137)**	**$ (817,085)**	**$ (598,714)**	**$ 6,898,141**	**$ (1,913,863)**	**$ (20,766,093)**	**$ 385,900**	**$ 173,917**	**$ (1,827,973)**

	Facilities												
	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifications and Eliminations	HHSC Consolidated
Operating Revenue													
Net patient service revenue - Net of provision for doubtful accounts	$ 14,363,174	$ 6,751,843	$ 30,106,335	$ 14,696,602	$ 510,938,684	$ -	$ -	$ 510,938,684	$ -	$ -	$ 2,328,617	$ -	$ 513,267,301
Other revenue	54,112	389,535	276,354	31,429	7,470,324	-	(319,302)	7,151,022	-	3,501,020	755,372	-	11,407,414
Total operating revenue	14,417,286	7,141,378	30,382,689	14,728,031	518,409,008	-	(319,302)	518,089,706	-	3,501,020	3,083,989	-	524,674,715
Operating Expenses													
Salaries and benefits	17,313,358	5,543,188	30,050,462	13,621,136	408,448,324	7,961,112	-	416,409,436	-	-	3,124,587	-	419,534,023
Purchased services	666,142	609,626	3,927,338	1,568,636	66,359,361	202,264	(319,302)	66,242,323	-	13,310	222,992	-	66,478,625
Medical supplies and drugs	386,215	561,715	2,135,374	357,002	70,043,687	-	-	70,043,687	-	-	127,452	-	70,171,139
Depreciation and amortization	486,582	503,791	1,477,009	474,337	25,668,363	596,091	-	26,264,454	-	870,373	126,619	-	27,261,446
Utilities	762,312	390,136	1,104,234	611,330	16,264,626	155,588	-	16,420,214	-	383,125	6,657	-	16,809,996
Repairs and maintenance	235,512	170,464	1,016,055	208,325	12,635,930	142,750	-	12,778,680	-	43,902	44,175	-	12,866,757
Other supplies	699,556	224,597	851,120	548,482	17,823,783	202,545	-	18,026,328	-	348,273	19,911	-	18,394,512
Professional fees	73,308	917,265	489,789	292,075	12,193,515	326,198	-	12,519,713	-	2,191,778	-	-	14,711,491
Insurance	122,333	59,844	367,922	137,524	5,254,448	19,855	-	5,274,303	-	85,717	105,867	-	5,465,887
Rent and lease	3,425	159,172	635,920	60,434	7,173,753	34,368	-	7,208,121	-	96,317	433,039	-	7,737,477
Other	60,051	169,303	690,226	78,183	7,943,682	458,424	-	8,402,106	(13,792)	116,430	201,163	-	8,705,907
Total operating expenses	20,808,794	9,309,101	42,745,449	17,957,464	649,809,472	10,099,195	(319,302)	659,589,365	(13,792)	4,149,225	4,412,462	-	668,137,260
Operating Loss (Income)	(6,391,508)	(2,167,723)	(12,362,760)	(3,229,433)	(131,400,464)	(10,099,195)	-	(141,499,659)	13,792	(648,205)	(1,328,473)	-	(143,462,545)
Nonoperating Revenue (Expenses)													
General appropriations from the State of Hawaii	2,744,753	1,500,000	5,181,507	2,157,068	73,375,585	-	-	73,375,585	-	-	-	-	73,375,585
Loss on disposal of capital assets	-	-	-	-	(542,617)	-	-	(542,617)	-	-	6,662	-	(535,955)
Restricted contributions	-	-	-	-	1,309,754	-	-	1,309,754	-	-	304,277	-	1,614,031
Interest expense	-	(40,074)	(160,461)	-	(1,186,824)	(1,607,376)	-	(2,794,200)	-	(909,728)	10,496	-	(3,693,432)
Interest and dividend income	40,522	-	8,808	22,378	279,505	23,908	-	303,413	-	6,977	-	-	310,390
Corporate allocation expense	(297,850)	-	(600,232)	(263,490)	(8,980,133)	8,980,133	-	-	-	-	-	-	-
Other nonoperating revenue (expenses) - Net	-	948,752	324,221	221,440	3,247,737	(271,269)	-	2,976,468	-	-	511,709	-	3,488,177
Total nonoperating revenue (expenses)	2,487,425	2,408,678	4,753,843	2,137,396	67,503,007	7,125,396	-	74,628,403	-	(902,751)	833,144	-	74,558,796
Excess of Revenue (Under) Over Expenses Before Capital Contributions	(3,904,083)	240,955	(7,608,917)	(1,092,037)	(63,897,457)	(2,973,799)	-	(66,871,256)	13,792	(1,550,956)	(495,329)	-	(68,903,749)
Capital Contributions	922,810	4,979,000	(25,000)	661,562	22,785,843	5,398,203	-	28,184,046	-	-	-	-	28,184,046
(Decrease) Increase in Net Assets	**$ (2,981,273)**	**$ 5,219,955**	**$ (7,633,917)**	**$ (430,475)**	**$ (41,111,614)**	**$ 2,424,404**	**$ -**	**$ (38,687,210)**	**$ 13,792**	**$ (1,550,956)**	**$ (495,329)**	**$ -**	**$ (40,719,703)**

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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Independent Auditor's Report

To the Board of Directors
Hawaii Health Systems Corporation

We have audited the financial statements of Hawaii Health Systems Corporation as of and for the year ended June 30, 2012 and have issued our report thereon dated January 11, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of Hawaii Health Systems Corporation is responsible for establishing and maintaining an effective internal control over financial reporting. In planning and performing our audit, we considered the Hawaii Health Systems Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and questioned costs, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying schedule of findings and questioned costs to be material weaknesses. See Findings 2012-01-04.

To the Board of Directors
Hawaii Health Systems Corporation

A significant deficiency is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying schedule of findings and questioned costs to be significant deficiencies. See Findings 2012-05-16.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Hawaii Health Systems Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Hawaii Health Systems Corporation's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit Hawaii Health Systems Corporation's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the board of directors, others within the entity, regulatory bodies, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Plante & Moran, PLLC

January 11, 2013

Schedule of Findings
Year Ended June 30, 2012

Finding - 2012-01

Organization - Alii Community Care, Inc.

Finding Type - Material weakness

Criteria - Property and equipment lapse schedules should be maintained. Reconciliation of the detailed lapse schedule to the general ledger is essential to ensure amounts presented in the financial statements are accurate.

Condition - A property and equipment lapse schedule is not being updated. Also, depreciation expense had not been recorded correctly in fiscal year 2012.

Context - Property and equipment amounts recorded in the general ledger did not have adequate supporting documentation.

Cause - Depreciation expense of approximately $870,000 needed to be recorded in fiscal year 2012.

Effect - The balance sheet and statement of operations were misstated throughout the year. An adjusting journal entry was posted to correct this misstatement.

Recommendation - We recommend management perform formal reviews of property and equipment accounts to ensure what is being reported is properly supported by lapse schedules or other detailed records. Additionally, management should record depreciation expense on a monthly basis to ensure net property and equipment amounts presented in internal financial statements are reasonably stated.

Views of Responsible Officials and Planned Corrective Actions - The Roselani Accountant will utilize Quickbooks or Excel to maintain capital asset balances and to compute then record depreciation expense on at least an annual basis. The HHSC liason will ensure that the amount is recorded at year end.

Finding - 2012-02

Organization - Alii Community Care, Inc.

Finding Type - Material weakness

Criteria - Operating lease expenses should be recorded in a straight-line manner over the course of the lease.

Condition - A straight-line rent expense calculation does not exist. Also, rent expense had not been recorded properly in fiscal year 2012.

Context - We identified that rent expense was being recorded in accordance with the lease agreement, not in a straight-line manner.

Cause - Additional rent expense of approximately $222,000 needed to be recorded during the year.

Effect - The balance sheet and statement of operations were misstated throughout the year. An adjusting journal entry was posted to correct this misstatement.

Recommendation - We recommend management and the board review general ledger accounts related to debt to ensure outstanding obligations are properly reflected in the general ledger.

Views of Responsible Officials and Planned Corrective Actions - At year end, the Alii Health Center (AHC) Director will ensure AHC's outside accountants record the journal entry for the straight-line adjustment related to operating leases under accounting principles generally accepted in the United States of America.

Finding - 2012-03

Organization - Alii Community Care, Inc.

Finding Type - Material weakness

Criteria - Financial statements should be reported on an accrual basis throughout the year.

Condition - Alii Community Care, Inc. reported financial results on a cash basis throughout 2012.

Context - Generally Accepted Accounting Principles requires accrual basis of accounting

Cause - Decision by management to report financial results on cash basis

Effect - Statement of operations were misstated throughout the year. Adjusting journal entries were posted to correct this misstatement.

Recommendation - We recommend that management review the decision to report financial results in accordance with Generally Accepted Accounting Principles on an interim basis.

Views of Responsible Officials and Planned Corrective Actions - HHSC management will revisit the issue of maintaining AHC on the cash basis of accounting for internal reporting purposes. For subsequent annual audits, AHC's financial statements will be drafted under the full accrual method of accounting.

Finding - 2012-04

Organization - East Hawaii Region

Finding Type - Material weakness

Criteria - Reconciliation of the accounts receivable subsidiary ledgers to the general ledger are essential to ensure amounts presented in the financial statements are accurate. Review of the reconciliations and detailed subsidiary ledgers is essential to ensure that amounts recorded in the financial statements are accurate and properly valued. In addition, a review of the information contained within the contractual model (contractual allowance/bad debt reserve percentages and credit balances) should be performed to ensure that the amounts recorded in the financial statements are accurate and properly valued.

Condition - Accounts receivable reconciliations and the contractual allowance workpapers are not formally reviewed in all circumstances. The result of the lack of controls resulted in an overstatement of $2,000,000 in the allowance for uncollectible accounts as compared to the contractual model. Additionally, the contractual allowance workpaper applied percentages based on 2010 payment history and was not updated to include the impact of credit balances. This led to an overstatement of allowance for uncollectible accounts of $183,202 and an understatement of allowance for contractual adjustments of $3,084,061.

Context - Accounts receivable reconciliations and other supporting schedules not being updated or reviewed

Cause - Procedures are not in place to complete and review accounts receivable reconciliations and supporting schedules.

Effect - The allowance for uncollectible accounts was overstated by $2,183,202, the allowance for contractual adjustments was understated by $3,084,061, and net patient service revenue was overstated by $900,859.

Recommendation - We recommend management implement a formal review process related to accounts receivable. Someone separate from the preparation process should review and sign-off on the various schedules that support the account receivable, allowance for uncollectible accounts, and allowance for contractual adjustments on a monthly/quarterly basis. All variances between the supporting schedules and the general ledger should be researched and resolved.

Views of Responsible Officials and Planned Corrective Actions - The Hawaii Health Systems Corporation - East Region is developing an accounts receivable analysis and process that will be reviewed quarterly by the Regional Finance Team and CFO. Management believes this additional control will provide the appropriate oversight to ensure proper reporting of accounts receivable.

Finding - 2012-05

Organization - Corporate

Finding Type - Significant deficiency

Criteria - Proper documentation for contracts obtained through procurement should be maintained to ensure compliance with internal policies.

Condition - Corporate has procedures in place to ensure proper documentation for all contracts obtained through procurements is maintained; however, documentation maintained by Corporate for three contracts was not adequate.

Context - Our review of 20 procurement files identified three files which lacked proper documentation.

Cause - Management did not follow procedures to ensure proper documentation is maintained.

Effect - Three procurement files do not have proper documentation of the procurement process.

Recommendation - Management should review their procedures in place to ensure proper documentation of the procurement contract files is maintained.

Views of Responsible Officials and Planned Corrective Actions - The corporate director of contracts will brief the corporate contract management team to reemphasize the importance of a complete and well-organized procurement file. The director of contracts will also require that all Corporate contract managers attend the State Procurement Office (SPO) sponsored procurement training programs as may be applicable to HHSC. The director of contracts will conduct periodic procurement file audits throughout the FY and require contract managers to use a contract file checklist developed by the director of contracts to make sure procurement methods and/or actions governed by HRS 103D, Hawaii Administrative Rules and HHSC Procurement Policies and Procedures are followed and documented correctly.

Finding - 2012-06

Organization - Corporate

Finding Type - Significant deficiency

Criteria - Accounts payable and expenditures should be reviewed for proper cutoff at year end.

Condition - Accounts payable and expenditures were not properly stated at June 30, 2012.

Context - Lack of proper review of 2012 expenditures posted subsequent to June 30, 2012

Cause - Management reviewed expenditures after year end, but did not properly record all expenditures at June 30, 2012.

Effect - Accounts payable and expenditures at June 30, 2012 were understated by approximately $250,000.

Recommendation - Management should review the detail of all expenditures subsequent to year end to determine proper cutoff at year end.

Views of Responsible Officials and Planned Corrective Actions - The corporate controller will communicate to management the importance of providing the accounting department with invoices in the period that goods are received or services rendered. Prior to year end, a follow-up communication will be sent by the corporate accountant to ensure that for all goods received and services rendered, an invoice is received. If an invoice is not received by a vendor, then an accrual estimate will be made by management.

Finding - 2012-07

Organization - Corporate

Finding Type - Significant deficiency

Criteria - Proper recognition of cash in escrow for capital lease obligations should be done for financial statement presentation.

Condition - Corporate has procedures in place to track cash in escrow for capital lease obligations; however, they did not properly record $8,842,551 as a capital lease obligation and assets limited as to use.

Context - Corporate did not have procedures in place to ensure cash in escrow was properly recorded.

Cause - Management was tracking cash in escrow for capital lease obligations; however, they did not record them properly.

Effect - Financial statements did not properly present cash held in escrow for capital lease obligations.

Recommendation - Management should review all cash held in escrow on a regular basis and review that funds are properly recorded.

Views of Responsible Officials and Planned Corrective Actions - The corporate accountant will review all escrow balances at month end and will ensure that both restricted cash and the related capital lease obligation is recorded for all remaining funds in the escrow account. The corporate controller will review all amounts each month to ensure balances are properly recorded.

Finding - 2012-08

Organization - Alii Community Care, Inc.

Finding Type - Significant deficiency

Criteria - General journal entries are not required to be reviewed before being posted.

Condition - It was noticed during year-end audit procedures that any individual who has access to the accounting system (Quickbooks) can post an entry into the system.

Context - Errors could be made when entries are made, and their effect could go unnoticed and uncorrected.

Cause - A restriction on the posting of journal entries is not in place. The accounting system should be modified so that an individual who creates a journal entry cannot post the entry to the system, or a formal policy should be adopted and followed where all manual entries are signed off on as being reviewed before being posted.

Effect - Unsupported or incorrect journal entries could be made to the system.

Recommendation - We recommend that a policy be put in place whereby all manual journal entries that are posted to the system, be approved by an individual not posting the entry, or the accounting system should be modified to not allow the creator of an entry to post that entry.

Views of Responsible Officials and Planned Corrective Actions - Although journal entries are not reviewed, monthly financial statements are reviewed by the HHSC liason on a monthly basis. Material errors would be detected.

Finding - 2012-09

Organization - Alii Community Care, Inc.

Finding Type - Significant deficiency

Criteria - The controls in place over information technology and other controls, are not sufficient to reliably prevent or detect inappropriate access and ability to change the following: accounting data (e.g., database information) and transaction information.

Condition - It was noticed during the audit that a password is not required for access to the accounting system (Quickbooks).

Context - All users to the accounting system should be required to enter a password to enter the system.

Cause - Not requiring users of the accounting system to enter a password before gaining access to the system

Effect - Unauthorized access could be gained into the accounting system and unsupported entries could be made.

Recommendation - We recommend that access to Quickbooks be limited by a password. In addition, a process for restricting access to terminated employees should be implemented.

Views of Responsible Officials and Planned Corrective Actions - HHSC management will investigate whether a password can be added to access the accounting system.

Finding - 2012-10

Organization - Alii Community Care, Inc.

Finding Type - Significant deficiency

Criteria - Proper recognition of disbursements

Condition - Rent expense was improperly recorded as a deposit, understating rent expense and overstating assets.

Context - Rent deposit was not recorded correctly in the general ledger. Rent expense was not recorded during the year.

Cause - Rent expense of $24,000 needed to be recorded in fiscal year 2012 and rent deposit needed to be recorded in accordance with the lease agreement.

Effect - The balance sheet and statement of operations were misstated throughout the year. An adjusting journal entry was posted to correct this misstatement.

Recommendation - We recommend that management review the recording of rent obligations and expenses to determine if they are in accordance with Generally Accepted Accounting Principles.

Views of Responsible Officials and Planned Corrective Actions - Although journal entries are not reviewed, monthly financial statements are reviewed by the HHSC liason on a monthly basis. Material errors would be detected.

Finding - 2012-11

Organization - East Hawaii Region

Finding Type - Significant deficiency

Criteria - Proper allocation of oversight responsibilities are essential to ensure amounts presented in the financial statements are accurate and properly supported.

Condition - Accrued employee compensation schedules and fixed asset reconciliations are not formally reviewed in all circumstances. The result of the lack of controls resulted in an overstatement of $441,634 in accrued expenses and an understatement of net capital assets of $840,868. In addition, a check run at the end of the year was not made available to vendors until after year end, resulting in an overstatement of due to affiliates and an understatement of accounts payable of $967,932.

Context - Accrued employee compensation schedules and fixed asset reconciliations are not being reviewed to ensure that the proper rates are being used or that the amounts on the schedules agree to the general ledger. In addition, check runs at the end of the year are not properly reviewed or evaluated for proper accounting treatment.

Cause - There is not an individual between the accounting manager and CFO to assist in the review of various schedules that are being prepared. The CFO has several monthly accounting responsibilities which include reviewing many of the supporting schedules.

Effect - Accrued expenses were overstated by $441,634, net capital assets were understated by $840,868, due to affiliates were overstated by $967,932, and accounts payable were understated by $967,932.

Recommendation - We recommend assigning some of the CFO's responsibilities, such as the review of workpapers prepared by the accounting manager, to another member within the finance staff in order to allow the CFO to perform oversight functions and to enable him to focus on the strategic and financial directives of the Hospital.

Views of Responsible Officials and Planned Corrective Actions - Management has assigned the financial analyst the responsibility to review the workpapers prepared by the accounting manager. The financial analyst will report the findings directly to the CFO on a monthly basis.

Finding - 2012-12

Organization - Kauai Region

Finding Type - Significant deficiency

Criteria - The status of construction in progress should be reviewed on a regular basis to ensure projects are capitalized and depreciation begins timely.

Condition - Invoices related to construction projects for Samuel Mahelona Memorial Hospital received in June were not capitalized appropriately. In addition, a voided payment was improperly included in the total capital contributions received from the State of Hawaii and capitalized in construction in progress for Samuel Mahelona Memorial Hospital.

Context - Lack of review of construction invoices subsequent to year end and lack of review of capital contributions and construction in progress additions schedule

Cause - Management was tracking the projects, but failed to capitalize amounts included on invoices received after year end to construction in progress. In addition, SMMH improperly included a voided payment in the total capital contributions received from the State of Hawaii and capitalized in construction in progress.

Effect - Interim financial statements did not properly reflect depreciable assets throughout the year.

Recommendation - On a regular basis, construction in progress accounts should be reviewed on a project basis. Management should review all invoices for construction in progress to determine that all amounts related to the current year are properly capitalized.

Views of Responsible Officials and Planned Corrective Actions - On a regular monthly basis, construction in progress accounts will be reviewed on a project basis. Management will review all invoices for construction in progress to determine that all amounts related to the current year are properly capitalized.

Finding - 2012-13

Organization - Kauai Region

Finding Type - Significant deficiency

Criteria - Accounts payable and expense should be reviewed for proper cut-off at year end.

Condition - Accounts payable and expense were not properly stated at June 30, 2012 for Samuel Mahelona Memorial Hospital.

Context - Lack of proper review of invoices received subsequent to year end at Samuel Mahelona Memorial Hospital

Cause - Management at Samuel Mahelona Memorial Hospital did not track the amounts billed subsequent to year end, and failed to include invoices received subsequent to year end in accounts payable at June 30, 2012.

Effect - Accounts payable and expense at June 30, 2012 were understated by approximately $30,000.

Recommendation - Management should review all invoices received subsequent to year end. Related invoices should be accrued in accounts payable at year end.

Views of Responsible Officials and Planned Corrective Actions - Accountant IV will review all invoices received subsequent to year end. Related invoices will be accrued in accounts payable at year end.

Finding - 2012-14

Organization - Maui Region

Finding Type - Significant deficiency

Criteria - When there is any turnover, the access levels and approval functions of the former employee should be reviewed and removed. This is vital to ensure that former employees do not authorize or approve any transactions that they should not have the proper approval to do so.

Condition - During year-end audit testing, it was noted that the former CFO was still listed as a signatory authority on bank accounts held by MMMC and Kula.

Context - Lack of controls surrounding access and approval functions of terminated employees

Cause - Procedures are not in place to remove all access levels and approval functions of former employees.

Effect - A former employee still had access to sign checks and approve transfers on behalf of MMMC and Kula.

Recommendation - We recommend management review the policies and procedures in place for termination of employees. This should include the review and termination of all access levels and approval functions that were granted to the former employee.

Views of Responsible Officials and Planned Corrective Actions - A request to modify signers was recently submitted to Bank of Hawaii.

Finding - 2012-15

Organization - Oahu Region

Finding Type - Significant deficiency

Criteria - Contractual allowance analysis prepared by the Kahuku controller should be independently reviewed on a regular basis and journal entries should be made to bring the amount listed in the general ledger to the amount determined based on the analysis. Additionally, a comparison of the payor mix used by the Kahuku analysis should be compared to the payor mix used in the corporate model to verify contractual percentages are properly applied.

Condition - A contractual allowance analysis was provided and showed the allowance booked in the general ledger was $192,000 understated compared to the analysis calculation. Additionally, the analysis was not independently reviewed and the individual payor categories for the account receivable balances did not tie to the accounts receivable aging provided by Corporate.

Context - A journal entry was made to increase the contractual allowance by $192,000 to make the balance consistent with the analysis.

Cause - Management determined the amount was reasonable and passed on booking without an independent review and without tying the payor categories to the Corporate analysis.

Effect - The contractual allowance was understated and required the posting of an audit adjusting journal entry.

Recommendation - We recommend Kahuku implement a formal policy, which will include a monthly review of the contractual allowance analysis along with a comparison to the Corporate model, and verify the proper amounts are recorded in the general ledger.

Views of Responsible Officials and Planned Corrective Actions - The KMC controller will ensure that the financial statements reflect the correct balances for the allowance for contractual adjustments. The contractual allowance reserve will be reviewed on a periodic basis by the KMC CFO.

Finding - 2012-16

Organization - Oahu

Finding Type - Significant deficiency

Criteria - Depreciation schedules prepared by the Kahuku Controller should be independently reviewed on a regular basis to ensure the depreciation is calculated properly and the expense is proper on the financial statement.

Condition - No formal review of the depreciation schedule or analysis completed on the depreciation expense balance

Context - An additional journal entry was booked to depreciation expense and accumulated depreciation in the amount of $176,379, which increased the overall balances. The entry was booked due to using incorrect and outdated depreciation schedules.

Cause - The depreciation schedule is not reviewed at this time and analysis is not completed on the depreciation expense balance by individuals other than the Kahuku Controller.

Effect - Depreciation expense was overstated and required the posting of an audit adjusting journal entry.

Recommendation - We recommend Kahuku implement a formal policy, which will include a monthly review of the depreciation schedule and an overall analysis of the depreciation expense line item in the financial statements.

Views of Responsible Officials and Planned Corrective Actions - The Kahuku Medical Center (KMC) Controller will ensure that the financial statements reflect the correct depreciation balances. The depreciation schedules will then be reviewed by the KMC Chief Financial Officer (CFO).