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# Financial Audit of the Kona Community Hospital

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A Report to the  
Governor  
and the  
Legislature of  
the State of  
Hawaii

Report No. 96-17  
November 1996



**THE AUDITOR**  
STATE OF HAWAII

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## The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds and existing funds meet legislative criteria.
7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.
8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.
9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



## THE AUDITOR STATE OF HAWAII

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# OVERVIEW

THE AUDITOR  
STATE OF HAWAII

## Financial Audit of the Kona Community Hospital

### Summary

The Office of the Auditor and the certified public accounting firm of Coopers & Lybrand, L.L.P. conducted a financial audit of the Kona Community Hospital for the fiscal year July 1, 1995 to June 30, 1996. The audit examined the hospital's financial records and its systems of accounting and internal controls and tested these for compliance with applicable laws and regulations. In the opinion of Coopers & Lybrand L.L.P., the financial statements of the hospital present fairly the financial position and results of operations for the year ended June 30, 1996.

We found that the Kona Community Hospital could improve its business office operations by implementing or revising certain procedures. The audit identified two reportable conditions, which, taken together, constituted a material weakness in the hospital's internal control structure. A material weakness in the internal control structure means that significant errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Specifically, we found that the hospital's financial accounting and reporting system needs to be improved and that improvements are also needed in the hospital's billing and collection system. Financial statements for management are not prepared in a timely manner and budgetary reporting should be improved. There are significant delays in charging patients' accounts for services provided, the billing system is not adequate to process long-term care charges, and certain rate charges to patients were less than the standard rate. Payments from third-party payors are not reviewed, other collections practices could improve collections, and there were delays in depositing certain cash receipts.

The audit identified other problems that limit the hospital's ability to limit costs or improve revenues. We found that an agreement for laboratory services is detrimental to the hospital. Cash discounts that amounted to approximately \$340,000 were taken by two third-party payors during the year. These discounts are not supported by written agreements. We also found that information system policies and procedures should be improved.

We noted that hospital management has begun to address many of the problems found. A new chief financial officer has been hired and, with support of the hospital administrator, has taken steps to make the needed improvements.

## Recommendations and Response

We recommend that management continue its efforts to improve the hospital's financial accounting and reporting system. We also recommend that improvements be made to its billings and collection system. Additionally, we recommend that the hospital be allowed to negotiate and enter into its own service contracts with vendors and ensure that rates under the contracts are fair. The hospital should seriously consider the need for the existing service contract. The hospital should also have the contractor bill patients and insurers for services directly, just as physicians do.

With respect to the cash discounts taken without support of written agreements, we recommend the Division of Community Hospitals continue to involve affected hospitals in resolving this issue, and that the hospital consider billing patients for any discounts taken.

With respect to the information system, we recommend that passwords for all computer applications be at least eight characters long and that they be changed periodically. We also recommend the development of a policy governing the use of the Internet and the development of a formal disaster recovery plan.

The department concurs with our findings and recommendations. The response by the department includes specific actions that are being taken to ensure that financial reporting objectives are met, resources are safeguarded, and operating efficiency is improved. Many of the actions are being taken through the newly organized Hawaii Health Systems Corporation established by Act 262 of the 1996 Legislature.

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Governor  
and the  
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the State of  
Hawaii

Conducted by

The Auditor  
State of Hawaii  
and  
Coopers & Lybrand  
L.L.P.

Submitted by

**THE AUDITOR**  
STATE OF HAWAII

Report No. 96-17  
November 1996



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## Foreword

This is a report of our financial audit of the Kona Community Hospital for the fiscal year July 1, 1995 to June 30, 1996. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Coopers & Lybrand L.L.P.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Kona Community Hospital.

Marion M. Higa  
State Auditor



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# Chapter 1

## Introduction

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This is a report of our financial audit of the Kona Community Hospital. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Coopers & Lybrand, L.L.P.

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of the transactions, accounts, programs and performance of all departments, offices, and agencies of the State and its political subdivisions.

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## Background

Kona Community Hospital is an acute and long-term care hospital located in Kealahou, Hawaii, and is one of 13 facilities administered by the Division of Community Hospitals of the Department of Health, State of Hawaii. The hospital was originally built in 1941 with subsidies from the federal government. The hospital's mission is to provide high quality comprehensive health care to the visitors and residents of Hawaii County.

The hospital occupies approximately eight acres of land, employs approximately 52 medical staff, and has an operating budget of approximately \$24 million. Currently, the hospital has 75 licensed beds as follows:

Acute Care	53 beds
Skilled Nursing Facility (SNF)	14 beds
Intermediate Care Facility (ICF)	<u>8 beds*</u>
Total	75 beds

\*ICF beds may also be used as SNF beds when necessary.

Act 211, Session Laws of 1995 established greater autonomy for the Division of Community Hospitals. The Act provided the division with greater flexibility in the use of its funds, reduced or eliminated the State's access to the division's special funds, eliminated certain state administrative charges to the division, and established control over procurement, rate-setting and other business decisions at the division level. In 1996, further autonomy was granted to the State's hospitals. Act 262, Session Laws of Hawaii 1996, authorized the transfer of all operations of the Division of Community Hospitals to the Hawaii Health Systems Corporation, an independent agency of the State. The Division of Community Hospitals and the Hawaii Health Systems Corporation have not yet determined the date of the transfer of operations.

### ***Organization of the hospital***

Kona Community Hospital is comprised of the following main functions:

- The Administration Office is responsible for overall administration and management of the hospital, development of policies and procedures, utilization review, and the establishment of goals and objectives.
- The Business Office provides accounting support, including financial management, maintenance of accounting records, and patient billings.
- Patient Care Services offers medical, surgical, ambulatory care, home care, psychiatric, and extended care services. The hospital also provides comprehensive support services, which aid in the proper diagnosis and treatment of patients. These services include: chemotherapy, dietary, health education, hemodialysis, laboratory, nuclear medicine, occupational therapy, physical therapy, respiratory therapy, and social services.

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### **Objectives of the Audit**

1. Report on the fair presentation of the financial statements of the hospital.
2. Assess the adequacy, effectiveness, and efficiency of the systems and procedures relating to the financial accounting, reporting, and internal controls of the hospital and recommend improvements to such systems, procedures, and reports.
3. Determine whether expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

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### **Scope and Methodology**

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the hospital for the fiscal year July 1, 1995 to June 30, 1996. All fund types and account groups of the hospital were included in our audit.

We also reviewed the hospital's transactions, systems, and procedures for compliance with applicable laws and regulations. The audit included a review of the hospital's accounting, reporting, and internal control structure. It also included a review of the hospital's forms, records, accounting, and operational procedures. Because Hilo Medical Center provides data processing for Kona Community Hospital, we also reviewed the data processing system controls at the Hilo Medical Center.

The audit was conducted from June 1996 through October 1996, in accordance with generally accepted auditing standards as set forth by the American Institute of Certified Public Accountants and the standards for financial audits as set forth in the U.S. General Accounting Office's *Government Auditing Standards* (1994). The independent auditors' opinion as to the fairness of the financial statements presented in Chapter 3 is that of Coopers & Lybrand L.L.P.



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# Chapter 2

## Internal Control Practices

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Internal controls are steps instituted by management to ensure that financial reporting objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of Kona Community Hospital.

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### Summary of Findings

We found that the Kona Community Hospital could improve its business office operations by implementing or revising certain procedures. We noted specific matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Although the reportable conditions individually are not material weaknesses, taken together, they constitute a material weakness in the internal control structure. The following findings are reportable conditions and are summarized as follows:

1. Financial reporting needs to be improved.
2. The hospital's billing and collection system needs improvement.

In addition to the reportable conditions described above, we found other areas on which management should focus to improve its business operations:

1. An agreement for laboratory services is detrimental to the hospital.
2. Cash discounts taken by two third-party payors are not supported by written agreements.
3. Information system policies and procedures should be improved.

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### Reportable Conditions Taken Together Constitute a Material Weakness

Reportable conditions involve significant deficiencies in the design or operation of the internal control structure. In our judgment, these conditions could adversely affect the hospital's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Internal controls have a pervasive effect on the hospital, and their absence can increase the risk of errors or irregularities in financial

statement accounts. A material weakness exists when controls are such that significant errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We believe that the two reportable conditions described above do not individually constitute a material weakness. However, taken together, they do since management does not receive timely financial reports to effectively monitor the hospital's operations. Furthermore, the billing and collection system is not adequate to ensure timely and accurate processing of transactions and collection of revenues.

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## **Financial Reporting Needs To Be Improved**

Management needs financial information on a timely basis to effectively monitor the hospital's financial position and results of operations. Currently management receives only monthly reports for cash receipts and accounts receivable balances. It should also receive financial statements, which include a balance sheet, a statement of revenues and expenses that compares actual amounts to budgeted amounts, and key operating statistics utilized in the healthcare industry.

*Financial statements for review by management are not prepared in a timely manner*

Monitoring of financial performance and cash position is essential for the future viability of the hospital. Monthly financial statements, which include a balance sheet and a statement of revenues and expenses, should normally take from two to three weeks to complete. The hospital took more than a year to provide adequate financial statements to management.

### **The hospital did not finalize its financial accounting reports on a timely basis**

In addition to delayed financial statements, the hospital's financial accounting reports for the fiscal year ended June 30, 1995 were not finalized until June 28, 1996. These reports include a general ledger, a balance sheet, and a statement of revenues and expenses. The hospital waited until all final adjustments from its previous independent auditor were received before finalizing the financial accounting reports for the year.

Because it waited — or “held open” — its 1995 accounting records until June 28, 1996, the financial and accounting reporting system could not produce reports for FY1995-96. As a result, no monthly financial accounting reports were prepared for the entire fiscal year ended June 30, 1996. The lack of monthly financial reports hampers management's ability to assess operations and deprives it of key information needed to make informed decisions.

The hospital should not rely on its independent auditors to determine when it is appropriate to finalize its annual accounting records. Instead, management should require that hospital accounting staff maintain adequate accounting records and finalize the hospital's accounting records in a timely manner.

**Expenditures are not recorded in the financial accounting and reporting system in a timely manner**

In July 1996 we found that expenditures recorded in the financial accounting and reporting system for the fiscal year ending June 30, 1996 reflected only those expenditures incurred from July through December 1995. The expenditures for January through June 1996 were recorded on a separate computer spreadsheet awaiting recording in the financial accounting and reporting system.

The delay in recording of expenditures also hampers reconciliation of the hospital's financial accounting and reporting system to the State's Financial Accounting and Management Information System (FAMIS). Since the information contained in FAMIS becomes the official accounting records of the State, it is imperative that periodic reconciliation of the hospitals records to FAMIS be performed. Reconciliation of records helps management to detect errors or irregularities in accounting records. At Kona Community Hospital, reconciliation of expenditures is performed only at the end of the fiscal year, which increases the risk of undetected errors in the hospital's financial accounting and reporting system and in FAMIS.

***Budgetary reporting  
should be improved***

Budgets should be prepared at the level of detail that is most meaningful for proper assessment. For the hospital, this detail might be required at the department level (e.g. Pharmacy, Surgery, Emergency Room, etc.) so that department managers can compare actual departmental performance against the budget and analyze significant variances. The hospital's budget is not prepared at this level of detail because it conforms only to the format required by the Department of Budget and Finance (B&F). Although B&F guidelines provide a uniform budgeting process that all state agencies must follow in reporting to the Legislature, this format is not sufficient in detail to be useful to the hospital's individual departments.

The hospital's financial accounting and reporting system can allow comparisons of departmental revenues and expenses to the budget. However, budgets are not being prepared at the departmental level and the system does not generate such reports. As a result, management cannot monitor departmental activity against budgets and plans.

***Other useful information should be provided to management***

Financial and operating performance measures commonly used in the industry should be prepared and analyzed by management each month against industry standards. These performance measures include patient capacity, payor mix, liquidity, productivity, and other measures. Kona Community Hospital's management, however, uses only monthly cash receipts, accounts receivable and patient visit count reports to monitor the hospital's financial and operating performance.

***Recent steps taken should help***

The hospital has recently hired a Certified Public Accountant as its Chief Financial Officer (CFO) who has begun to address some of the accounting and financial reporting issues. She is also a member of a task force that is in the process of evaluating the financial accounting and reporting needs of all of the division's hospitals. The task force is considering alternative financial accounting and reporting systems.

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***Recommendations***

We recommend that management continue its efforts to improve the financial accounting and reporting system. In doing so we recommend that:

1. The hospital finalize its financial accounting reports shortly after the end of the fiscal year;
2. Management ensure that expenditures are recorded in the hospital's financial accounting and reporting system and reconciled to FAMIS reports in a timely manner; and
3. Monthly financial reports be prepared for review by management. These reports at a minimum should include monthly financial statements, departmental comparisons of budget versus actual results, and financial and operating performance measures commonly used in the industry.

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**The Hospital's Billing and Collection System Needs Improvement**

The primary source of revenues for private, profit-oriented medical facilities is the billing and collection of patient service revenue. In order to operate independently, the hospital must be able to properly bill for its services and ensure the timely collection of amounts due. One indication of the efficiency and effectiveness of a hospital's billing and collection system is the age of its accounts receivable. As of June 30, 1996, the hospital had approximately \$23 million in gross accounts receivable. Of this, the hospital expects that approximately \$8.5 million will be uncollectible. About \$7.3 million of accounts receivable is more than five months old. We found that improvements are needed in many areas.

***There are significant delays in charging patients' accounts for services provided***

Delays in posting charges to patient accounts have resulted in delayed billings and collections and/or rejection of billings by third-party payors. We found time lags of 1-25 days between the dates of services and the dates that patients' accounts were charged for these services. In several instances we found time lags of more than 120 days.

The hospital has a policy that requires daily submission of charge sheets to the business office for posting to patient accounts. The hospital's policy that charge sheets be submitted daily to the business office is not being enforced.

***Billing system is not adequate to process long-term care charges***

The hospital has 22 long-term care beds and revenues from long term-care were approximately \$1.7 million for the year ended June 30, 1996. We found that billings for long-term care must be processed manually because the existing automated system cannot process long-term care charges into the prescribed billing format. The process delays the time it takes to collect payments, not only because these bills must be manually processed, but because the hospital cannot take advantage of electronic claims processing offered by third-party payors.

To compound the problem the current billing system sets the maximum number of cycles (months) per patient account number at twelve. As a result, each long-term care patient must be discharged and re-admitted and assigned a new patient account number after twelve months to account for their charges. It should be noted that patients are not physically discharged, but paperwork must be processed as such in order to establish new patient account numbers.

***Certain rates charged to patients were less than the standard rate***

Hilo Medical Center is responsible for maintaining charge rates in Kona Community Hospital's billing system including inputting any changes to the rates. Rates are reviewed by the management of Kona Community Hospital only for overall reasonableness. We found that certain room rates in the billing system were not in accordance with the rate structure authorized by the Division of Community Hospitals because Hilo Medical Center did not input authorized increases to the hospital's billing system. As a result, Kona Community Hospital underbilled third-party payors and patients during FY1995-96.

***Payments from third-party payors are not reviewed***

Since the hospital's billing rates often differ from amounts insurers and other third-party payors are contractually obliged to pay, third-party payors generally pay only a portion of the hospital's billings. The hospital does not calculate the amount expected to be collected from third-party payors when a bill is submitted to the third-party payor. As a result, the hospital does not know how much is actually due from third-

party payors. When payments are received, the hospital accepts whatever payments it receives and writes off the difference as contractual adjustments and/or transfers the difference to a "self-pay" category to be collected from the patient. The hospital could potentially be losing revenues from these third-party payors as there is currently no review of such third-party payments.

***Other collection practices should be considered***

After reviewing the hospital's receivables at the end of the 1995-96 fiscal year, Kona Community Hospital's CFO determined that an allowance of 9.4 percent of revenues was needed to compensate for possible uncollectible accounts. This compares unfavorably to the more than 6 percent of the past two years' revenues and an industry average of about 3 percent. The hospital's current practice is to admit patients, provide services, bill third-party payors, then bill patients any balances due. This means that patients are the *last to be billed*. If a patient has no insurance coverage or is not a resident of the Kona area, the patient is billed for all services only after services are provided. These billing practices increase the risk that patients' accounts may become uncollectible.

The hospital does not have formal procedures to discuss charges for services with patients, to provide an estimate of the patient's share of charges, and to determine the patient's ability to pay. In addition, the hospital does not collect prepayments from patients prior to discharge, accept installment note agreements, nor provide referrals to financial institutions. All of these are accepted hospital collection practices and should be pursued to reduce the risk of uncollectible accounts.

***Delays found in depositing certain cash receipts***

One standing rule of business is that "All cash receipts be deposited on a daily basis." The hospital does not deposit receipts that cannot readily be matched to particular patient accounts or that may represent overpayments. Instead, the hospital maintains a "pending file" of these cash receipts in a safe. On July 9, 1996, checks in the pending file, which included some dated as early as January 1, 1996, totaled approximately \$6,600. The delay in processing and depositing cash receipts results in lost cash flow to the hospital as well as the potential for checks to become stale-dated. The hospital should discontinue the use of the "pending file."

The preferred practice is to deposit the money when it is received, then investigate and determine the disposition of the receipt. If a refund is due, it can be processed when a determination of an overpayment has been made.

***Initiatives to make improvements***

Management has informed us that a task force comprising representatives from each hospital in the Division of Community Hospitals is currently addressing the issue of long-term care billing and evaluating alternatives to improve the effectiveness and efficiency of its entire automated billing and collection system. However, this is not enough. Management should be looking also at other ways to improve the hospital's billings and collections.

***Recommendations***

1. The hospital should enforce its policy of requiring daily submission of charge sheets to the business office for posting to patient accounts.
2. Hospital management should consider the implementation of an electronic billing system for long-term care charges.
3. The hospital should ensure that billing rates are properly maintained in the billing system by Hilo Medical Center. Monitoring procedures should include comparing billing rates in the system to billing rates authorized by the Division of Community Hospitals and recalculating formula-based billing rates on a test basis.
4. The hospital should not unquestioningly accept payments from third-party payors. It should determine the amount it expects to receive from third-party payors, compare payments received against those amounts, and follow-up when payments received differ from what was expected.
5. The hospital should improve its collection practices to include discussion of charges with patients, collecting prepayments from patients prior to discharge, and accepting credit card payments and installment note agreements. It should also consider referring patients to financial institutions to arrange for loans to pay their hospital bills.
6. The hospital should deposit all cash receipts on a daily basis. It should discontinue the practice of holding cash receipts.

**Agreement for Laboratory Services is Detrimental to the Hospital**

The hospital is bound by a contractual agreement with a vendor to provide laboratory services to its patients. The vendor charges the hospital for the laboratory services at rates established in the contract. The hospital then bills patients for these services at rates set forth by third-party payors or in accordance with the hospital's rate schedule.

We found that the hospital is losing money with this agreement because of a financially detrimental negotiation made by the Division of

Community Hospitals. Amounts billable to patients are often less than amounts paid to the contractor. For example, the hospital must pay the vendor at rates specified in the contract. However, the hospital often receives only a fraction of the amounts billed by the contractor from third-party payors. Depending on the agreements with third-party payors, the hospital may be prevented from obtaining the balance from patients.

Table 2.1 below represents a sample of five outpatient laboratory charges for a certain third-party payor:

**Table 2.1  
Sample of Outpatient Charges**

	Total charge allowed by third-party payor	Amount paid to the contractor	Amount recoverable from patient	Cost to be borne by hospital
1.	\$21.50	\$64.00	\$0.00	\$42.50
2.	6.50	21.00	0.00	14.50
3.	20.00	16.36	3.64	0.00
4.	36.00	45.00	0.00	9.00
5.	16.00	55.20	0.00	39.20

**Recommendations**

The hospital should be allowed to negotiate and enter into its own service contracts with vendors. In doing so, it should ensure that rates billed for laboratory services under the contract are fair in light of third-party payor practices and the hospital's rate schedule. The hospital should also seriously consider the need for this service contract and have the contractor bill patients and insurers for services directly in a manner similar to that practiced by physicians.

**Cash Discounts Taken by Two Third-party Payors Are Not Supported by Written Agreements**

For the past several years, Hawaii Medical Services Association (HMSA) and Kaiser Foundation Health Plan (Kaiser) have been paying the hospital, at discounted amounts, for services provided to their members. HMSA discounts 9.5 percent from billings for inpatient services and Kaiser discounts 12.5 percent from billings for services to inpatients and outpatients. The hospital and the Division of Community Hospitals do not have any written agreements that authorize HMSA and

Kaiser to take these cash discounts. Management of the hospital has estimated that the total HMSA and Kaiser cash discounts were approximately \$340,000 for the fiscal year ended June 30, 1996.

Consistent with the finding contained in our Report No. 96-6, *Financial Audit of Maui Memorial Hospital and Hana Medical Center*, we could not find in the HMSA contract any mention of the 9.5 percent discount. In addition, Kaiser has no written contract with the hospital; it simply deducts 12.5 percent from the hospital's billings and pays the discounted amount to the hospital.

The hospital's management has chosen not to pursue collection of the cash discounts from HMSA, Kaiser, or even the patients to whom services were provided. The hospital records these discounts as "contractual adjustments," which are potential revenues that are written off.

***Discussions with HMSA and Kaiser have begun***

The Division of Community Hospitals has informed us that it is currently negotiating the issue of these discounts with HMSA and Kaiser. We understand the division involves affected hospital administrators in these discussions. The division should ensure that any discounts negotiated with HMSA and Kaiser are consistent with industry practices.

***Recommendations***

We recommend that the Division of Community Hospitals continue to involve affected hospitals in resolving the issue of discounts with HMSA and Kaiser. We also recommend that the hospital consider billing patients for any discounts taken.

**Information System Policies and Procedures Should Be Improved**

The hospital utilizes the same information system that Hilo Medical Center operates and maintains. We found that Hilo Medical Center's policies and procedures for its information system should be improved.

***Password security policies and procedures need to be improved***

Passwords are a critical control component in any technological environment. Passwords of less than eight characters that are easy to guess may give unauthorized users the ability to make harmful changes to sensitive programs and data. Also, passwords should be changed periodically to reduce the risk that unauthorized users access the system. We found that passwords for certain computer applications are only four characters long and are not required to be changed on a periodic basis.

***There are no policies to restrict access to the Internet***

More security problems exist with the hospital's use of the Internet for remote communications. As the use of the Internet increases, a proactive policy regarding management's policies on controlled and acceptable uses of the Internet via the hospital's systems and networks becomes critical. We noted that policies and guidelines relating to accessing the Internet have not been formally communicated. Substantial time may be spent by employees using the Internet for unauthorized personal purposes.

***There are still no disaster recovery plans***

We found that the Kona Community Hospital and Hilo Medical Center have not formalized a disaster recovery plan. We previously pointed out the need for a disaster recovery plan in our Report No. 96-4, *Financial Audit of the Hilo Medical Center*.

Disaster recovery plans play a key role in preventing the interruption of business processing when a catastrophic event occurs. Without one, the hospital may not be able to recreate lost data in all of its information systems when a catastrophic event occurs.

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***Recommendations***

The hospital should discuss these issues relating to the information system with management of the Hilo Medical Center to ensure that appropriate corrective actions are taken. Specifically, we recommend that:

1. Passwords for all computer applications be at least eight characters long and that they be changed periodically;
2. A formal policy that governs the use of the Internet should be prepared; and
3. Kona Community Hospital and Hilo Medical Center should prepare a formal disaster recovery plan.

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# Chapter 3

## Financial Audit

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This chapter presents the results of the financial audit of Kona Community Hospital (hospital) for the year ended June 30, 1996. It includes the independent auditors' report and reports on the internal control structure and compliance with laws and regulations. It also displays financial statements, together with explanatory notes, and supplemental schedules.

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### Summary of Findings

In the opinion of Coopers & Lybrand L.L.P., based on their audit, the financial statements present fairly, in all material respects, the financial position of the hospital at June 30, 1996, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

Coopers & Lybrand L.L.P. noted certain matters involving the internal control structure and its operation that they considered to be reportable conditions, which, taken together, constitute a material weakness as defined in the report on the internal control structure. They also noted no instances of noncompliance with laws and regulations applicable to the hospital that are required to be reported under *Government Auditing Standards*.

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### Independent Auditors' Report

To the Auditor  
State of Hawaii

We have audited the following financial statements of Kona Community Hospital (hospital):

Balance sheet - June 30, 1996 (Exhibit A);

Statement of revenues and expenses of unrestricted funds - year ended June 30, 1996 (Exhibit B);

Statement of changes in fund balances - year ended June 30, 1996 (Exhibit C);

Statement of cash flows of unrestricted funds - year ended June 30, 1996 (Exhibit D).

These financial statements are the responsibility of the management of the hospital. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit 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 audit provides a reasonable basis for our opinion.

As discussed in the notes to the financial statements, the financial statements present only the activities of the hospital and are not intended to present fairly the financial position of the State of Hawaii and the results of its operations and the cash flows of its proprietary fund type in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the hospital as of June 30, 1996, and the results of its operations and cash flows of unrestricted funds for the year then ended in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental information included in Schedules I to V are presented for purposes of additional analysis and are not a required part of the basic financial statements. This information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on Schedules I to V.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 9, 1996 on our consideration of the hospital's internal control structure and a report dated October 9, 1996 on its compliance with laws and regulations.

/s/ Coopers & Lybrand L.L.P.

Honolulu, Hawaii  
October 9, 1996

**Independent  
Auditors' Report  
on the Internal  
Control Structure  
Based on an Audit  
of Financial  
Statements  
Performed in  
Accordance with  
Government  
Auditing Standards**

To the Auditor  
State of Hawaii

We have audited the financial statements of Kona Community Hospital (hospital) as of and for the year ended June 30, 1996, and have issued our report thereon dated October 9, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the hospital is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the hospital for the year ended June 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the hospital's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The following reportable conditions are more fully described in Chapter 2:

1. The hospital's financial reporting needs to be improved.
2. The hospital's billing and collection system needs to be improved.

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the following matter involving the internal control structure and its operation that we consider to be a material weakness as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of the hospital for the year ended June 30, 1996.

The reportable conditions referred to above and described more in detail in Chapter 2, do not individually constitute a material weakness. However, taken together these uncorrected conditions reveal a material weakness in the overall management control environment. Management controls have a pervasive effect on the organization and their absence can increase the risk of errors or irregularities in many critical financial statement accounts. The weaknesses in Kona Community Hospital's overall management control environment include the inability to

monitor the financial operations of the hospital on a timely basis and the billing and collection system is not adequate to ensure timely and accurate processing of transactions and collection of revenues.

We also noted other matters involving the internal control structure and its operation that we have reported to the Auditor, State of Hawaii, and management of Kona Community Hospital, which are described in Chapter 2.

This report is intended for the information of the Auditor, State of Hawaii, and management of Kona Community Hospital. However, this report is a matter of public record and its distribution is not limited.

/s/ Coopers & Lybrand L.L.P.

Honolulu, Hawaii  
October 9, 1996

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**Independent  
Auditors' Report  
on Compliance  
Based on an Audit  
of Financial  
Statements  
Performed in  
Accordance with  
Government  
Auditing Standards**

To the Auditor  
State of Hawaii

We have audited the financial statements of Kona Community Hospital (hospital) as of and for the year ended June 30, 1996, and have issued our report thereon dated October 9, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts and grants applicable to the hospital is the responsibility of the hospital's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the hospital's compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the Auditor, State of Hawaii and the management of Kona Community Hospital. However, this report is a matter of public record and its distribution is not limited.

/s/ Coopers & Lybrand L.L.P.

Honolulu, Hawaii  
October 9, 1996

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## Descriptions of Financial Statements

The following is a brief description of the financial statements audited by Coopers & Lybrand L.L.P. The financial statements are attached at the end of this chapter.

Balance sheet (Exhibit A). This statement presents assets, liabilities, and fund equity of all fund types used by the hospital on an aggregate basis.

Statement of revenues and expenses of unrestricted funds (Exhibit B). This statement presents revenues and expenses of unrestricted funds used by the hospital on an aggregate basis.

Statement of changes in fund balances (Exhibit C). This statement presents changes in fund balances for all fund types used by the hospital on an aggregate basis.

Statement of cash flows of unrestricted funds (Exhibit D). This statement presents cash flows from operating, investing, and financing activities of the hospital's unrestricted funds on an aggregate basis.

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## Notes to Financial Statements

Explanatory notes, which are pertinent to an understanding of the financial statements and financial condition of the funds included in the scope of the audit, are discussed in this section.

### *Note 1 - Description of organization*

Kona Community Hospital (hospital) is an acute and long-term care hospital located in Kealahou, Hawaii and is part of the Division of Community Hospitals (Division) of the Department of Health, State of

Hawaii. The Department of Health administers the operations and maintenance of the hospital and establishes the rates for services through the Division. The Division's central office oversees the activities of the hospital and maintains contact with state government agencies responsible for budgeting, accounting, purchasing, and personnel. Through June 20, 1995, the State of Hawaii appropriated general funds for the difference between the hospital's receipts and expenditures and for certain improvement projects. Effective June 20, 1995, Act 211, Session Laws of Hawaii 1995 (Act 211) established greater autonomy for the Division. Act 211 provides the Division with greater flexibility in the use of its funds, reduces or eliminates the State's access to the Division's special funds, eliminates certain State administrative charges to the Division, and establishes control over procurement, rate-setting and other business decisions at the Division level. Effective July 1, 1996, Act 262, Session Laws of Hawaii 1996, authorized the transfer of all operations of the Division to the Hawaii Health Systems Corporation (Corporation), an independent agency of the State. The Division and the Corporation have not yet determined the date of the transfer of operations. Act 262 also amended Act 211 to retroactively exempt the hospital from the allocation of central service and departmental administration expenses to January 1, 1970 (see Note 7).

**Note 2 - Summary of significant accounting policies**

The accompanying financial statements are presented in accordance with pronouncements of the Government Accounting Standards Board (GASB) and the *Audits of Providers of Health Care Services*, published by the American Institute of Certified Public Accountants (AICPA). In June 1996, the AICPA issued a new audit and accounting guide entitled *Health Care Organizations (Guide)* which supersedes *Audits of Providers of Health Care Services*. The hospital will adopt the provisions of the Guide on the effective date for the hospital's financial statements beginning July 1, 1996. Management has not yet determined the effect of the adoption of the Guide on the hospital's financial statements.

**Use of estimates.** The preparation of financial statements in conformity with generally accepted accounting principles 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Patient service revenue.** 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 accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

**Inventories.** Inventories are valued at the lower of cost (determined by first-in, first-out method) or market.

**Property, plant and equipment.** Property, plant and equipment are stated at cost. Donated items are recorded at estimated fair market value at the date of donation. Expenditures which materially increase values, change capacities, or extend useful lives are capitalized. Depreciation is computed under the straight-line method to amortize the cost of the assets over their estimated useful lives, which range from 5 to 40 years.

Maintenance and repairs are charged to expense as incurred.

Capital improvement projects are under the management of the Department of Accounting and General Services. At the completion of the project the related costs are transferred to the appropriate property, plant and equipment accounts and depreciated.

**Vacation pay and compensatory pay.** The hospital has adopted the practice of fully accruing all vacation and compensatory pay at current salary rates. Vacation is earned at the rate of one and three-quarters working days for each month of service. Vacation days may be accumulated to a maximum of ninety days.

**Patients' safekeeping deposits.** Patients' safekeeping deposits represent cash or property belonging to patients, which are held by the hospital in fiduciary capacity as custodian. Receipts and disbursements of these funds are not reflected in the hospital's operation.

**Grants and donations.** Restricted grants and donations are credited directly to the applicable fund balance. Resources restricted for specific operating purposes are transferred to the unrestricted fund and reflected as other operating revenues to the extent expended by the unrestricted fund during the year. Funds which are restricted for plant replacement and expansion are transferred from the restricted to the unrestricted fund to the extent expended within the year.

Unrestricted grants and donations are recorded as nonoperating revenue.

**General obligation bond interest.** The hospital reports as expenses the charges for the interest paid by the State of Hawaii for general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is reported as nonoperating revenue. The bonds are obligations of the State of Hawaii, to be paid by the State of Hawaii's General Funds, and are not reported as liabilities of the hospital.

Interest costs incurred on borrowed funds during the period of construction are capitalized as component of the cost of acquiring the assets.

**Contributed services.** Volunteers have made contributions of their time in furtherance of the hospital's services. The value of this contributed time is not reflected in these financial statements since it is not susceptible to objective measurement or valuation.

**Cash and cash equivalents.** Cash includes moneys in the State Treasury and two Hawaii-based banks. The State Treasury maintains an investment pool for all state moneys. Hawaii Revised Statutes (HRS) authorize the Director of Finance to invest any moneys of the State which in the Director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State. Investments authorized by HRS include 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. Information relating to the bank balance, insurance, and collateral of cash deposits is determined on a statewide basis and not for individual departments or divisions. For purposes of the statements of cash flows, the hospital considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

***Note 3 - Contracts with third-party payors***

The hospital is reimbursed for services provided to patients under certain programs administered by governmental agencies. Reimbursement for these services, depending on the type of program and time period, is based on either a prospective payment system or on a cost methodology as defined in the regulations and principles prescribed by the U.S. Department of Health and Human Services.

Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system which is based on clinical, diagnostic, and other factors. The hospital's payment classification of patients under the Medicare prospective payment system is subject to review based on a validation audit by the program's professional review organization.

Inpatient nonacute services, outpatient services and defined capital and medical education costs related to Medicare beneficiaries are paid based upon a cost reimbursement methodology. The hospital is reimbursed on the basis of interim rates during the year with final settlement determined after submission of annual cost reports by the hospital and audits by the Medicare fiscal intermediary. Such cost reports have been audited by the Medicare fiscal intermediary through June 30, 1994.

Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed based upon a prospective payment system. The hospital's Medicaid cost reports have been audited by the Medicaid fiscal intermediary through June 30, 1994.

The hospital has also entered into reimbursement agreements with certain commercial insurance carriers and preferred provider organizations. The basis for reimbursement under these agreements include prospectively determined rates per discharge, discounts from established charges and prospectively determined per diem rates.

**Note 4 - Due from Medicare and Medicaid**

The amounts due from (to) Medicare and Medicaid at June 30, 1996 consist of reimbursements under cost reports submitted for the following fiscal years:

Years Ended:	<u>Medicare</u>	<u>Medicaid</u>	<u>Total</u>
June 30,			
1996	\$(90,000)	\$ -	\$(90,000)
1995	192,160	7,356	199,516
1994	<u>184,409</u>	<u>11,685</u>	<u>196,094</u>
	<u>\$286,569</u>	<u>\$19,041</u>	<u>\$305,610</u>

**Note 5 - Net transfer to the Division of Community Hospitals and Hilo Medical Center**

Transfers in (out) for the year ended June 30, 1996 were as follows:

Net transfer to the Division of Community Hospitals	\$(4,355,566)
Unreimbursed services rendered by Hilo Medical Center	<u>174,334</u>
	<u>\$(4,181,232)</u>

**Transfers to the facility administration fund.** The facility administration fund was established under Section 323-73, HRS to defray the general administrative costs of the division and to provide supplemental funds to those public health facilities which do not have sufficient moneys in their special funds to cover their required lawful operating expenditures, including contingencies for correcting hospital deficiencies cited by agencies which monitor and evaluate the division. The division transferred \$4.6 million from the hospital to the facility administration fund during the year.

**Community Hospitals Administration (CHA) cost allocation.** The division allocates a portion of its administrative expenses, referred to as CHA expenses, to each public health facility on an annual basis. CHA expense allocated to the hospital was \$282,693 for the year. The

division informed the hospital that no liability for the CHAS expense for the year should be recognized since no repayment is anticipated. Accordingly, the hospital recognized an operating transfer from the division of \$282,693 for the year ended June 30, 1996.

**Note 6 - Retirement benefits**

**Employees' retirement system.** Substantially all eligible employees of the hospital are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. Prior to June 30, 1984, the plan consisted of only a contributory option.

In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under Social Security. Persons employed in positions not covered by Social Security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

Required employer contributions to the ERS are based on actuarially determined rates that should provide sufficient resources to pay member pension benefits when due. The funding method used to calculate the total employer contribution required is the frozen initial liability method, and includes amortization of the accrued unfunded liability of pension benefits and post retirement benefits fixed at \$470 million over a period of twenty-eight years beginning July 1, 1987. The hospital's policy is to fund its required contribution annually. The payroll for employees of the hospital covered by the ERS for the year ended June 30, 1996 was \$10,766,274. The hospital's total payroll was \$11,785,454. The contribution requirement for the year ended June 30, 1996 for the hospital and its employees was \$1,411,028. The contribution represented approximately 13 percent of the hospital's covered payroll.

Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the hospital. The disclosures required by Governmental Accounting Standards Board Statement No. 4 are presented in the ERS Comprehensive Annual Financial Report (CAFR). The following data is provided as of June 30, 1995 for the entire ERS from the disclosures contained in the CAFR for the year then ended:

Pension benefit obligation	\$7,389,908,600
Net assets available for benefits, at cost (fair value \$5,963,630,000)	<u>5,599,057,315</u>
Unfunded pension benefit obligation	<u>\$1,790,851,285</u>

The pension benefit obligation is a standardized measure of the present value of credited projected pension benefits, adjusted for the effects of projected salary increases, estimated to be payable in the future as a result of employee service to date.

Ten-year historical trend information showing the ERS' progress in accumulating sufficient assets to pay benefits when due is presented in the ERS CAFR.

The entire ERS actuarially determined employer contribution requirements were met as of June 30, 1995.

**Post retirement health care and life insurance benefits.** In addition to providing pension benefits, the State provides certain health care and life insurance benefits to retired State employees. Contributions are based upon negotiated collective bargaining agreements and are funded by the State as accrued. The hospital's share of the expense for post-retirement health care and life insurance benefits for the year ended June 30, 1996 amounted to \$558,206.

**Note 7 - Due to State  
of Hawaii**

Amounts payable to the State of Hawaii as of June 30, 1996 were as follows:

Central service expenses allocated to the hospital pursuant to Section 36-27 of the Hawaii Revised Statutes	\$6,919,677
Department of Health administrative overhead allocated to the hospital pursuant to Section 36-30 of the Hawaii Revised Statutes	480,779
Receipts in excess of special fund appropriation payable to the general fund of the State of Hawaii	7,537,717
Allocated insurance and other costs	<u>70,988</u>
	<u>\$15,009,161</u>

Effective July 1, 1993, Act 211 exempted the hospital from the allocation of central service and departmental administration expenses. Accordingly, no such expenses were recorded for the fiscal year ended June 30, 1996. On July 1, 1996, Act 262 amended Act 211 to change the effective date of the exemption from the allocation of central service and departmental administration expenses to January 1, 1970. Accordingly, on July 1, 1996, Act 262 eliminated the hospital's liability of \$6,919,677 for central service expenses and \$480,779 for Department of Health administrative overhead expenses. The elimination of the total liability of \$7,400,456 owed to the State will also result in an increase in unrestricted fund balance on July 1, 1996. The following shows the pro forma balance sheet accounts of the hospital assuming Act 262 was effective on June 30, 1996 (unaudited):

Due to State of Hawaii	<u>\$7,608,705</u>
Unrestricted fund balance	<u>\$14,571,093</u>

### **Note 8 - Contingencies**

**Professional Liability.** The hospital was self-insured against professional liability claims from June 1, 1986 to June 1, 1988. All claims occurring after June 1, 1986 did not result in any liability to the hospital. Instead, such claims, if any, were paid out of the State of Hawaii's General Fund. During this same period, the hospital had purchased "tail coverage" on professional liability claims up to \$1,000,000 per claim and \$5,000,000 in the aggregate on a claims-made basis for claims which occurred from June 1, 1985 through June 1, 1986, but reported subsequent to June 1, 1986. Effective July 1, 1988, the hospital was insured on professional liability claims up to \$10,000,000 per claim and no limit in the aggregate on a claims-made basis.

The Attorney General, State of Hawaii, advises that any judgments rendered against the hospital in excess of the hospital's professional liability coverage as a result of pending or threatened litigation will require special legislative appropriations and will not be charged against the hospital's appropriations.

**Workers' Compensation Claims.** The hospital is self-insured for workers' compensation claims. It pays a portion of wages for injured workers, medical bills, and judgments as stipulated by the State of Hawaii, Department of Labor. The hospital accrues a liability for the expected cost of open claims, based on historical data and the amount of claims paid during the year ended June 30, 1996. The method of making such estimates and establishing the resulting accrued liability are reviewed continually and any judgments resulting therefrom are reflected in the current operations. At June 30, 1996, the estimated liability for workers' compensation benefits was \$223,000.

**Accumulated Sick Leave.** Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit. It

may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a State employee who retires or leaves government service in good standing with sixty days or more of unused sick leave shall be entitled to additional service credit in the Employees' Retirement System. Accumulated sick leave at June 30, 1996 aggregated approximately \$2,166,000.

**Deferred Compensation Plan.** The State established a deferred compensation plan (Plan) in accordance with Section 457 of the Internal Revenue Code which enables State employees to defer a portion of their compensation. The State of Hawaii, Department of Human Resources Development, has the fiduciary responsibility of administering the Plan. The deferred compensation is not available to employees until termination, retirement, death, or an unforeseeable emergency.

All amounts of compensation deferred under the Plan; all property and rights purchased with those amounts; and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the State's general creditors. Participants' rights under the plan are equal to those of the general creditors of the State in an amount equal to the fair market value of the deferred account for each participant. The assets of the Plan and the deferred compensation payable are recorded in the State of Hawaii's Employee Benefits Agency Fund.

***Note 9 - Obligations under capital leases***

The hospital leases hospital equipment under capital leases. Included in property, plant and equipment are equipment acquired under capital lease obligations with capitalized costs of \$358,084 net of accumulated amortization of \$620,914. Amortization expense on equipment under capital lease obligations for the year ended June 30, 1996 was \$168,117.

Future minimum payments required under the leases together with their present value as of June 30, 1996 are as follows:

Years ending June 30,	
1997	\$127,250
1998	100,020
1999	56,080
Thereafter	—
Total minimum lease payments	283,350
Less amount representing interest	9,957
Present value of minimum lease payments	273,393
Less current portion	120,877
Noncurrent portion	<u>\$152,516</u>

**Note 10 - Property, plant and equipment**

Property, plant and equipment as of June 30, 1996 included the following:

Buildings and improvement	\$12,244,151
Equipment	4,617,245
Equipment under capital lease	<u>978,997</u>
	17,840,393
Less accumulated depreciation and amortization	<u>7,607,577</u>
	10,232,816
Land	52,313
Construction work in progress	<u>373,294</u>
Property, plant and equipment, net	<u>\$10,658,423</u>

**Kona Community Hospital  
Balance Sheet - June 30, 1996  
Assets**

Unrestricted Fund:

## Current Assets:

## Cash:

On deposit with the State of Hawaii	\$2,455,705
Patients' trust fund	6,886
Collections revolving fund	431
On hand	<u>3,500</u>

Total cash	<u>2,466,522</u>
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## Receivables:

Patient accounts receivable, net of allowance for uncollectible accounts of \$8,480,676 and contractual adjustments of \$4,456,791	9,959,433
Due from Medicare and Medicaid	305,610
Other receivables	<u>47,768</u>

Total receivables	<u>10,312,811</u>
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Inventories	1,358,934
Prepaid Expenses	<u>18,000</u>

Total current assets	<u>14,156,267</u>
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Property, plant and equipment, net of accumulated depreciation and amortization of \$7,607,577	<u>10,658,423</u>
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Total unrestricted fund	<u>24,814,690</u>
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Restricted fund:

Gift trust funds: Cash with the State of Hawaii	20,087
Total restricted fund	<u>20,087</u>

Total assets	<u>\$24,834,777</u>
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*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital  
Balance Sheet - June 30, 1996  
Liabilities and Fund Balances**

Unrestricted funds:	
Current liabilities:	
Current portion of obligations under capital leases	\$120,877
Accounts payable and accrued expenses	555,861
Accrued salaries and wages	204,242
Accrued vacation and compensatory pay	1,298,514
Patients' safekeeping deposits	6,886
Due to State of Hawaii	15,009,161
Other accrued liabilities	292,013
Security deposit	<u>3,983</u>
Total current liabilities	<u>17,491,537</u>
Obligations under capital leases, noncurrent	152,516
Fund balance	<u>7,170,637</u>
Total unrestricted fund	<u>24,814,690</u>
<u>Restricted fund:</u>	
Gift trust funds: Fund Balance	<u>20,087</u>
Total restricted fund	<u>20,087</u>
	<u><u>\$24,834,777</u></u>

*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital**  
**Statement of Revenues and Expenses of Unrestricted funds**  
**for the Year Ended June 30, 1996**

Net patient service revenue	<u>\$25,570,846</u>
Other operating revenues:	
Rental income	105,000
Cafeteria	44,381
Other	<u>40,777</u>
Total other operating revenues	<u>190,158</u>
Total operating revenues	<u>25,761,004</u>
Operating expenses:	
Nursing services	9,374,905
Other professional services	5,604,371
General services	2,591,896
Fiscal and administrative services	6,132,266
Provision for uncollectible accounts	2,442,817
Provision for depreciation and amortization	<u>1,015,981</u>
Total operating expenses	<u>27,162,236</u>
Loss from operations	<u>(1,401,232)</u>
Nonoperating revenue (expense):	
Net transfer to the Division of Community	
Hospitals and Hilo Medical Center	(4,181,232)
Contribution from State of Hawaii for payment of interest	61,000
Interest expense	(69,706)
Contribution of assets and cash	<u>10,570</u>
Net nonoperating revenue (expense)	<u>(4,179,368)</u>
Excess of expenses over revenues	<u>\$(5,580,600)</u>

*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital  
Statement of Changes in Fund Balances  
for the Year Ended June 30, 1996**

Unrestricted fund:

Fund balance, beginning of year	\$12,489,403
Excess of expenses over revenues	(5,580,600)
Transferred from restricted plant improvement fund for improvement expenditures	264,988
Transferred to gift trust funds	(7,527)
Transferred from gift trust funds to finance property, plant and equipment expenditures	<u>4,373</u>
Fund balance, end of year	<u><u>\$7,170,637</u></u>

Restricted funds:

<u>Gift trust funds</u>	
Fund balance, beginning of year	\$16,933
Donations	7,527
Transferred to unrestricted fund for equipment purchased	<u>(4,373)</u>
Fund balance, end of year	<u><u>\$20,087</u></u>
 <u>Plant improvement fund</u>	
Fund balance, beginning of year	\$600
Transferred to unrestricted fund for plant improvement	(264,988)
Appropriations from the Public Works Division of the Department of Accounting and General Service	<u>264,388</u>
Fund balance, end of year	<u><u>\$ -</u></u>

*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital**  
**Statement of Cash Flows of Unrestricted Funds**  
**for the Year Ended June 30, 1996**

Cash flows from operating activities:	
Loss from operations	(1,401,232)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Loss on disposal of fixed assets	12,355
Depreciation and amortization	1,015,981
Unreimbursed services rendered by Hilo Medical Center	174,334
Hospital costs allocated by Division of Community Hospitals Administration	282,693
Increase in patient accounts receivable	(389,836)
Decrease in due from Medicare and Medicaid	343,437
Decrease in due from Kaiser Permanente	322,000
Increase in other receivables	(30,485)
Increase in inventories	(132,557)
Increase in prepaid expenses	(4,711)
Decrease in accounts payable and accrued expenses	(337,211)
Decrease in accrued salaries and wages	(1,185)
Increase in accrued vacation and compensatory pay	76,265
Decrease in accrued other liabilities	(162,296)
Increase in security deposit	<u>150</u>
Net cash used in operating activities	<u>(232,298)</u>

(Continued on next page)

*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital**  
**Statement of Cash Flows of Unrestricted Funds**  
**for the Year Ended June 30, 1996**  
**(Continued)**

Cash flows from noncapital financing activities:	
Increase in patients' safekeeping deposits	4,066
Transfer to the Division of Community Hospitals	<u>(4,584,859)</u>
Net cash used for noncapital financing activities	<u>(4,580,793)</u>
Cash flows from capital and related financing activities:	
Purchase of property and equipment	(372,824)
Contributions received	10,570
Capital lease obligation payments	(208,251)
Bond interest	(53,400)
Interest paid	(16,306)
Transfers to gift trust funds	(7,527)
Transfers from gift trust funds	<u>4,373</u>
Net cash used in capital and related financing activities	<u>(643,365)</u>
Net decrease in cash	(5,456,456)
Cash, beginning of year	<u>7,922,978</u>
Cash, ending of year	<u><u>\$2,466,522</u></u>
<u>Supplemental disclosure of non-cash transactions</u>	
Unreimbursed services rendered by Hilo Medical Center	<u>\$174,334</u>
Hospital costs paid by the Division of Community Hospitals	<u>\$282,693</u>
Capitalized interest contributed by the State of Hawaii	<u>\$7,600</u>

*The accompanying notes are an integral part of the financial statements*

**Kona Community Hospital  
Selected Hospital Statistics  
for the Years Ended June 30, 1996 and 1995  
(Unaudited)**

	1996	1995
<b>NUMBER OF LICENSED BEDS:</b>		
Acute	53	53
SNF	14	16
SNF/ICF Swing	<u>8</u>	<u>8</u>
Total	<u>75</u>	<u>77</u>
<b>NUMBER OF NURSING UNITS</b>	<u>7</u>	<u>7</u>
<b>OCCUPANCY:</b>		
Patient days:		
Acute	14,650	14,302
Newborn	1,136	1,101
Long-term	<u>7,797</u>	<u>7,930</u>
Total	<u>23,583</u>	<u>23,333</u>
Percentage occupancy:		
Acute	75.7%	73.9%
Newborn	UNK	UNK
Long-term	89.0%	90.5%
<b>SUNDRY PATIENT DATA</b>		
Admissions:		
Acute	3,331	3,493
Long-term	24	26
Other(newborn)	<u>616</u>	<u>594</u>
Total	<u>3,971</u>	<u>4,113</u>
Newborn deliveries	<u>616</u>	<u>594</u>
Discharges:		
Acute	3,339	3,470
Long-term	35	26
Other(newborn)	<u>618</u>	<u>596</u>
Total	<u>3,992</u>	<u>4,092</u>
<b>MEALS SERVED - PATIENTS</b>	<u>57,661</u>	<u>58,400</u>

*See independent auditors' report*

**Kona Community Hospital  
Selected Hospital Statistics  
for the Years Ended June 30, 1996 and 1995  
(Unaudited)**

	1996	1995
AVERAGE DAILY CENSUS	<u>64.6</u>	<u>63.9</u>
POUNDS LAUNDERED	<u>327,192</u>	<u>303,398</u>
AVERAGE LENGTH OF STAY (DAYS)		
Acute	4.4	4.1
Long term	222.8	305.0
AVERAGE TOTAL NET REVENUE PER PATIENT DAY COMBINED	\$1,084	\$1,098
AVERAGE TOTAL COST PER PATIENT DAY COMBINED	\$1,152	\$1,074
DEPARTMENTAL DATA:		
Surgical Procedures	2,513	2,686
Inpatient	1,075	1,408
Outpatient	1,438	1,278
Radiological Examinations	14,037	14,538
ER Registrations	11,773	12,458
Outpatient Visits (Nonemergency)	UNK	UNK
Home Health Services	NA	NA
Pharmacy Prescriptions Filled	UNK	UNK
Physical Therapy Services	6,117	4,032
Occupational Therapy Services	38,943	48,868
Operations (Number of Minutes)	219,453	216,714
Anesthetics Given (Number of Minutes)	221,566	200,869

NA: Not applicable

UNK: Information not available

*See independent auditors' report*

**Kona Community Hospital**  
**Supplemental Schedule of Reconciliation of Cash on Deposit with the State of Hawaii**  
**as of June 30, 1996**  
**(Unaudited)**

UNRESTRICTED FUNDS:

## SPECIAL FUNDS

S-92-354-H	\$ 10,137
S-94-354-H	2,407,363
S-95-354-H	16,195
S-96-354-H	<u>838</u>

Total cash on deposit with the State of Hawaii	<u>2,434,533</u>
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## RECONCILING ITEMS

Unrestricted private trust fund donations reclassified to restricted funds	19,451
Unrestricted public donations reclassified to restricted funds	<u>1,721</u>

Total cash per balance sheet	<u>\$2,455,705</u>
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RESTRICTED FUNDS:

## GIFT TRUST FUNDS:

T-96-915-H	<u>\$21,808</u>
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Total cash on deposit with the State of Hawaii	<u>21,808</u>
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## RECONCILING ITEMS

Unrestricted public donations reclassified to restricted funds	<u>(1,721)</u>
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Total cash per balance sheet	<u>\$20,087</u>
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*See independent auditors' report*

**Kona Community Hospital  
Modified Cash Flow Report  
for the Year Ended June 30, 1996  
(Unaudited)**

**RECEIPTS:**

Medicare	\$4,606,872
Medicaid	2,210,312
HMSA	6,265,146
Quest	2,734,186
Kaiser Permanente	1,549,712
Other third parties	4,483,904
Patients	1,553,369
Other state payments	16,935
Sale of meals	43,589
Other	<u>21,111</u>

Total receipts 23,485,136

**EXPENDITURES AND ENCUMBRANCES:**

Initial allocation, includes collective bargaining augmentation 25,080,000

Less excess of allocation over expenditures and encumbrances (669,544)

Total expenditures and encumbrances 24,410,456

Excess of expenditures and encumbrances over receipts (925,320)

Reversion of prior year expenditures and encumbrances 1,115,565

Division of Community Hospitals transfers (4,638,259)

Transfer to DAGS Public Works (20,000)

Unencumbered cash balance, July 1, 1995 5,583,345

Unencumbered cash balance, June 30, 1996 \$1,115,331

*See independent auditors' report*

Schedule IV

Kona Community Hospital  
Aging of Accounts Receivable  
June 30, 1996 and 1995  
(Unaudited)

	1996	1995
Unbilled	\$2,801,118	\$2,975,808
Current	5,020,727	3,830,446
31 - 60 Days	2,600,135	1,990,715
61 - 90 Days	1,634,808	1,295,743
91 - 120 Days	2,476,914	1,128,640
121 - 150 Days	1,081,752	599,348
OVER 151 Days	<u>7,281,446</u>	<u>9,494,900</u>
Gross patient accounts receivable	22,896,900	21,315,600
Less:		
Allowance for doubtful accounts	(8,480,676)	(7,437,167)
Allowance for contractual adjustments	<u>(4,456,791)</u>	<u>(4,308,836)</u>
Net patient accounts receivable	<u>\$9,959,433</u>	<u>\$9,569,597</u>

*See independent auditors' report*





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## Response of the Affected Agency

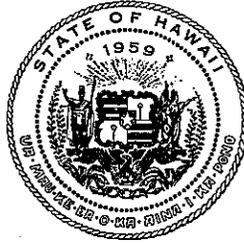
### Comments on Agency Response

We transmitted a draft of this report to the Department of Health on November 4, 1996. A draft of the report was transmitted also to the Kona Community Hospital. A copy of the transmittal to the Department of Health is included as Attachment 1. A similar letter was sent to the Kona Community Hospital. The Department of Health, in consultation with the Kona Community Hospital, responded for both, and that response is included as Attachment 2.

The department concurs with our findings and recommendations. The response by the department includes specific actions that are being taken to ensure that financial reporting objectives are met, resources are safeguarded, and operating efficiency is improved. Many of the corrective actions are being taken through the newly organized Hawaii Health Systems Corporation established by Act 262 of the 1996 Legislature.

ATTACHMENT 1

STATE OF HAWAII  
OFFICE OF THE AUDITOR  
465 S. King Street, Room 500  
Honolulu, Hawaii 96813-2917



MARION M. HIGA  
State Auditor  
(808) 587-0800  
FAX: (808) 587-0830

November 4, 1996

*COPY*

The Honorable Lawrence Miike  
Director of Health  
Department of Health  
Kinau Hale  
1250 Punchbowl Street  
Honolulu, Hawaii 96813

Dear Dr. Miike:

Enclosed for your information is a copy, numbered 9 of our draft report, *Financial Audit of the Kona Community Hospital*. We ask that you telephone us by Friday, November 8, 1996, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Friday, November 15, 1996.

The Kona Community Hospital, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa  
State Auditor

Enclosure

BENJAMIN J. CAYETANO  
GOVERNOR OF HAWAII



LAWRENCE MIIKE  
DIRECTOR OF HEALTH

**STATE OF HAWAII**  
DEPARTMENT OF HEALTH  
P.O. BOX 3378  
HONOLULU, HAWAII 96801  
November 18, 1996

In reply, please refer to:  
File:

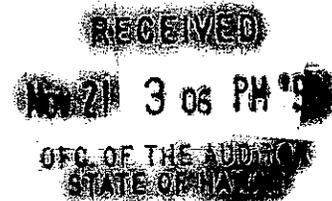
BK-96-247

**MEMORANDUM**

**TO:** Marion Higa, State Auditor  
Office of the Legislative Auditor

**FROM:** Lawrence Miike, Director *J. Miike*  
Department of Health

**SUBJECT:** **RESPONSE TO STATE AUDITOR'S FINANCIAL AUDIT OF KONA  
COMMUNITY HOSPITAL**



We have received the draft audit report for Kona Community Hospital (KCH), fiscal year ended June 30, 1996, and acknowledged the unqualified opinion on the financial statements. Certain reportable conditions were stated in the summary of findings. We appreciate the recommendations provided by the Legislative Auditor. Management is in the process of establishing certain procedures to ensure that financial reporting objectives are met, resources are safeguarded, and operating efficiency is improved.

In response to the findings of specific matters involving the internal control structure and the operations of KCH, management is working to address the following weaknesses.

**FINDING:** *Financial reporting needs to be improved.*

**RESPONSE:**

The Division of Community Hospitals (DCH) of the Department of Health is in need of information systems that provide timely clinical and financial information. The Finance and Information Systems Committee of the Hawaii Health Systems Corporation (HHSC) and the Hawaii Health Information Technology Service (HHITS) Task Force is in the process of selecting and implementing the necessary information systems. This Task Force provides services for all thirteen community hospitals. The HHITS Task Force meets monthly and is currently working the following projects:

- o Management has made a recommendation to the Board of Directors of HHSC to purchase the Long-Term Computer Systems (LTCS). This system will provide a complete general ledger, accounts payable, materials management, and payroll systems for all rural and long-term care community hospital facilities. The cabling for the software is projected to be completed by February 1997. The installation of the LTCS software will be possible after the cabling is completed. The go-live target date is May 1997.
- o The second recommendation that management will propose to the Board of Directors is the purchase of the accounts payable and materials management software modules from HBO & Company (HBOC). These modules will interface with the existing general ledger and provide on-line, real-time expense, and inventory information for all acute care community hospitals. The HHITS Task Force will assist in the implementation of this project.

The HHITS team will also work with the Finance and Information Systems Task Force to assist in the selection of decision support, timekeeping, and scheduling software. These software systems will allow various financial and clinical reporting capabilities such as:

- o Budgets can be prepared at the level of detail that is most meaningful for proper assessment.
- o Financial reporting with comparisons of departmental revenues and expenses to the budget.
- o Timekeeping and scheduling software will enable staffing by acuity, payroll budgeting, automated leave records, and timely payroll expense information.

Once the various software packages are installed, the community hospitals will have access to on-line, real-time clinical and financial information. This will enable management to monitor financial performance and cash position on a timely basis as well as comply with the recommendations of the Legislative Auditor which include:

- o Financial statements be finalized shortly after the end of the fiscal year.

- o Expenditures which are recorded in the hospital's financial accounting and reporting system be reconciled to FAMIS reports in a timely manner.
- o Preparation of monthly financial statements which provide departmental comparisons for budget to actual as well as other financial and operating performance measures commonly used in the industry.

**FINDING:** *The hospital's billing and collection system needs improvement.*

**RESPONSE:**

Management is aware that improvements to the Billing Office are needed to ensure the timely collection of revenue. We are working on the following procedures to increase cash flow as well as decrease the age of the accounts receivable:

- o Management will enforce its policy of requiring daily submission of charge sheets to the Business Office for posting to patient accounts. This procedure will decrease delayed billings and/or rejection of billings by third-party payors.
- o The installation of the LTCS software will enable long-term care billing to be automated which will help to improve the effectiveness and efficiency of the billing and collection system. KCH received authorization from Medicare in September 1996 to submit EMC claims. The Billing Office currently submits these claims electronically: Medicare SNF parts A and B, and DHS SNF and ICF routine and ancillary.
- o The information systems personnel maintain the charge description master at KCH. Management has established a policy that requires any changes to the chargemaster be given to the Chief Financial Officer as well as the Information Specialist. This procedure should help to ensure that the chargemaster is revised on a timely basis in accordance with the rate structure authorized by the DCH.
- o DHS payments are reviewed by the Billing Office staff for proper perspective payment system (PPS) payments. However, many other payments are grouped as one Diagnostic Related Grouping (DRG) reimbursement; therefore, it has been difficult to ascertain the

propriety of these payments. Management will recommend that a software package be purchased to help monitor third-party payor reimbursement. This software would enable the Billing Office staff to determine the amount the hospital expects to receive from third-party payors, compare payments received against those amounts, and follow-up when payments received differ from what was expected.

- o The grouper software will be installed the second week of December 1996. This software will group charges to optimize revenue by DRG reimbursement.
- o Management is developing a protocol for collecting estimated co-payments from patients before discharge. This procedure would include discussion of charges with patients, accepting credit card payments and setting up installment note agreements. This will help to increase cash flow as well as decrease uncollectible accounts.
- o Cash receipts are now being deposited into the bank in a timely manner.

One of the problems with revenue collections is the fact that as a State facility, we are the provider of last resort. Therefore, we provide a significant amount of charity care. Many patients are indigent and have no way of paying their medical expenses. In reality, the revenue that was classified as bad debt expense is primarily charity care. Although management is actively working to increase operating efficiency and effectiveness, we have no control over the economy in our community. We continue to provide quality care even when collection of revenue is highly improbable.

***FINDING: Agreement for laboratory services is detrimental to the hospital.***

**RESPONSE:**

The laboratory services contract negotiated by the DCH expires on June 30, 1997. HHSC management recently designated a special committee to initiate the process of negotiating a new laboratory services agreement. The goal of this committee is to assure that rates for quality laboratory services are at least comparable with the rates paid by other Hawaii hospitals for similar services.

**FINDING:** *Cash discounts taken by two third-party payors are not supported by written agreements.*

**RESPONSE:**

HHSC management is in the process of renegotiating the contracts with third-party payors such as HMSA and Kaiser. These contract negotiations are ongoing and each contract will be supported by a written, signed agreement.

**FINDING:** *Information system policies and procedures should be improved.*

**RESPONSE:**

The information system specialists will be upgrading the HBOC information system to V5R4 in January 1997. At that time, two levels of security to the AS/400 will be established at Hilo Medical Center (HMC) and KCH. Each employee will be assigned an individual user eight character login password which will control access to the AS/400. Secondary security will be provided by another password (four characters) which will be used to access the HBOC applications. A separate login password for the local area network (LAN) will also be required. These procedures should help to provide proper access to the information system which will help safeguard sensitive programs and data. Additional security control file features include:

- o The eight character login to the AS/400 and to the LAN will expire every 90 days and new login codes will be generated. Users will be recognized by their login ID. IDs must be requested by the security liaison and assigned by the Security Administrator in HHSC's Systems Security Section.
- o Maximum number of invalid attempts before automatic sign-off will be three.
- o Inactivity time-out will occur after ten minutes.
- o No duplicate passwords will be generated.

The DCH does not have access to the Internet; however, the HHITS team is developing a plan for Internet access and policies and procedures will be included in that plan.

Marion Higa, State Auditor  
November 18, 1996  
Page Six

The following disaster recovery plan has been developed and formalized by the HHITS Task Force:

- o The information specialists at HMC will back-up journals daily, programs weekly, HBOC system monthly, and the entire AS/400 system bi-monthly. Back-up data is stored on magnetic tapes and is stored off-site in a fireproof vault. These tapes store all information for both HMC and KCH.
- o Monthly back-up is to be tested. This procedure will test both the integrity of the magnetic tape as well as the data.

This disaster recovery plan should help ensure that data is not lost if a catastrophic event occurs.

We appreciated the opportunity to update you on our efforts to improve our operations and we appreciate your interest in following the progress of some of our accomplishments.

