Audit of Selected Procurement, Human Resource, and Fiscal Issues of the Hawaii Health Systems Corporation

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

Report No. 04-03
February 2004

THE AUDITOR
STATE OF HAWAII

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 are 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.

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OVERVIEW

Audit of Selected Procurement, Human Resource, and Fiscal Issues of the Hawaii Health Systems Corporation

Report No. 04-03, February 2004

Summary

The Hawaii Health Systems Corporation was created in 1996 as an independent agency administratively attached to the Department of Health. It replaced the department's Division of Community Hospitals, which had been operating Hawaii's community hospital system since 1989. Act 262, Session Laws of Hawaii 1996, stated that the overriding goal in creating the corporation was to provide better health care for Hawaii's people, including those served by small rural facilities, by freeing the facilities from unwarranted bureaucratic oversight. However, Act 262 also requires the corporation to develop policies and procedures for procurement consistent with the goals of public accountability and public procurement practices, and encourages the use of provisions of the Hawaii Public Procurement Code.

The corporation, governed by a 13-member board of directors, operates 12 public hospitals and health facilities on five islands and is one of the largest public health systems in the country. The hospitals are divided into five regions, each managed by a chief executive officer under the overall management responsibility of the corporate president and chief executive officer. The corporation has about 3,200 employees and operates more than 1,100 beds, providing critical/acute inpatient care, skilled and intermediate nursing care, and ambulatory outpatient care.

Since its inception, the corporation has depended on subsidies from the Legislature for both operations and improvements to hospital infrastructures. The State's general fund subsidy has ranged from $8.2 million to over $29 million, comprising between 4 and 11 percent of the corporation's total appropriation. In addition, the corporation's function as a "safety-net" hospital contributes to its fiscal challenges.

Although reliance on some state subsidies is expected, weaknesses in the corporation's management of procurement add to its dependence on state funding. The corporation has not embraced the State's commitment to open, competitive bidding, but instead adopted procurement practices that clash with government accountability. Lenient policies and a lack of oversight facilitate discretionary contract abuses and result in millions of dollars in non-bid contract awards. Other local hospitals do use bidding in their procurement process. In addition to this long-standing problem, a business venture with a contractor raises questions about self-dealing.

We also found that the corporation's hiring practices increase costs, risk substantial liabilities and penalties, and may violate payroll tax laws and the State's Fair Treatment Standards. Hiring of expensive independent contractors to perform essentially the same functions as lower-paid employees illustrates an award process that emphasizes convenience over competition. Furthermore, misclassified independent contractors may expose the corporation to substantial liabilities for taxes and penalties and corporate perks to management-level employees are difficult to reconcile with government accountability.

The corporation uses municipal leases as a way to raise money for equipment and infrastructure improvements. Municipal leases are not subject to the legislative budget approval process and do not affect the State's debt ceiling; however, if the corporation is unable to make the required lease payments, the Legislature could find itself obliged to provide funding beyond intended levels to ensure medical services continue uninterrupted and hospitals remain open. The corporation has committed to over $53 million in municipal leases for equipment purchases, infrastructure improvements, and services expansions. In addition, we found that, in spite of its massive need for capital, the corporation does not have a comprehensive, long-term capital-spending plan for the entire hospital system, and cost-benefit projections for planned projects have been seriously flawed.

We also found that the corporation's inventory management lacks adequate, uniform standards and oversight to ensure that assets are properly accounted for and safeguarded. Critical accountability tasks are not properly segregated, inventory records are inaccurate or inadequate, and identification tags are not consistently used.

Recommendations and Response

To address the problems we identified, we recommended that the corporation's board strengthen oversight and improve policies on procurement; develop policies for hiring of independent contractors; reassess its termination and separation policies; and establish accountability standards for analyses and projections for capital investments. Our recommendations to the corporation's management include implementing open competitive procurement policies; ensuring that independent contractors are hired in accordance with applicable laws and regulations; developing a long-term capital spending plan; ensuring the accuracy and completeness of capital investment analyses and projections; using general obligation bonds for major infrastructure projects to the extent possible; and establishing uniform standards for accounting for and safeguarding capital assets. Finally, we recommended that the Legislature clarify its intent on the application of Chapter 103F, HRS, to the corporation and require the corporation to provide adequate information on new municipal leases for infrastructure improvement and service expansions as part of its budget review process.

The corporation and the members of its board generally disagreed with a number of our findings and recommendations. Their responses indicate that the corporation's procurement practices, which diverge from government norms, are justified by alleged statutory exemptions, a position not supported by our findings. Further, the responses differ from our recommendation to allow municipal leases to undergo the same budgetary scrutiny that applies to other long-term debt commitments.

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

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 04-03
February 2004

Foreword

This is a report of our audit of selected procurement, human resource, and fiscal issues of the Hawaii Health Systems Corporation. This 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.

We wish to express our appreciation for the cooperation and assistance extended to us by the Hawaii Health Systems Corporation and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

Since its inception in 1996, the Hawaii Health Systems Corporation has been the focus of legislative scrutiny. Legislators have expressed numerous concerns about whether the corporation is managed in an effective and efficient manner. Concerns have been prompted, in part, by the corporation's repeated requests for emergency appropriations.

In response to such concerns, the State Auditor initiated this audit pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct post-audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background on the Corporation

The Hawaii Health Systems Corporation was created in 1996 as an independent agency administratively attached to the Department of Health. It was designed to replace the department's Division of Community Hospitals. That division had been operating Hawaii's community hospital system since 1989, but had suffered inefficiencies from burdensome government procedures that hindered hospital financial management and operations.

Act 262, Session Laws of Hawaii (SLH) 1996, stated that the overriding goal in creating the corporation was to provide better health care for Hawaii's people, including those served by small rural facilities, by "freeing the facilities from unwarranted bureaucratic oversight." The act also specified that in case of a conflict between appropriate health care and bottom-line decisions, quality health care should be given precedence to the extent reasonably possible.

The corporation, however, must also be mindful of the obligations derived from receiving taxpayer moneys to cover operating losses. In its *Government Auditing Standards*, the U.S. General Accounting Office outlines the basic responsibilities that apply to anyone entrusted with managing public resources. These include:

1. Resources must be applied efficiently, economically, and effectively;

2. Programs must be in compliance with applicable laws and regulations; and

3. Controls must be in place to ensure appropriate goals and objectives are met, resources safeguarded, laws and regulations followed, and reliable data obtained, maintained, and fairly disclosed.

The Legislature codified some of these responsibilities by requiring the corporation to develop policies and procedures for procurement consistent with the goals of public accountability and procurement practices. The Legislature also encouraged the corporation to use provisions of the Hawaii Public Procurement Code.

Mission and governance

The corporation's mission is to provide accessible, comprehensive health care services that are quality-driven, customer-focused, and cost-effective. It has developed three strategies by which to accomplish this mission:

1. Create a patient-centered, integrated system that cares for its customers;

2. Create a positive work environment by investing in employees through training, resources, recognition, rewards, and encouraging a sense of ownership; and

3. Partner with physicians in planning and providing an optimal infrastructure for quality care.

Transfer of the state public hospitals' administration from the Division of Community Hospitals to the corporation resulted in significant changes to hospital governance and operations, including the creation of a board to govern the corporation and regional advisory committees to assist corporate management in carrying out its responsibilities; transfer of title to all properties, facilities, and equipment from the Department of Health to the corporation; centralization and standardization of contract administration for health insurance companies and major vendors; standardization of equipment and medical practices statewide; and conversion of the accounting system from governmental fund accounting to generally accepted accounting principles, the method used by private-sector corporations.

Organization

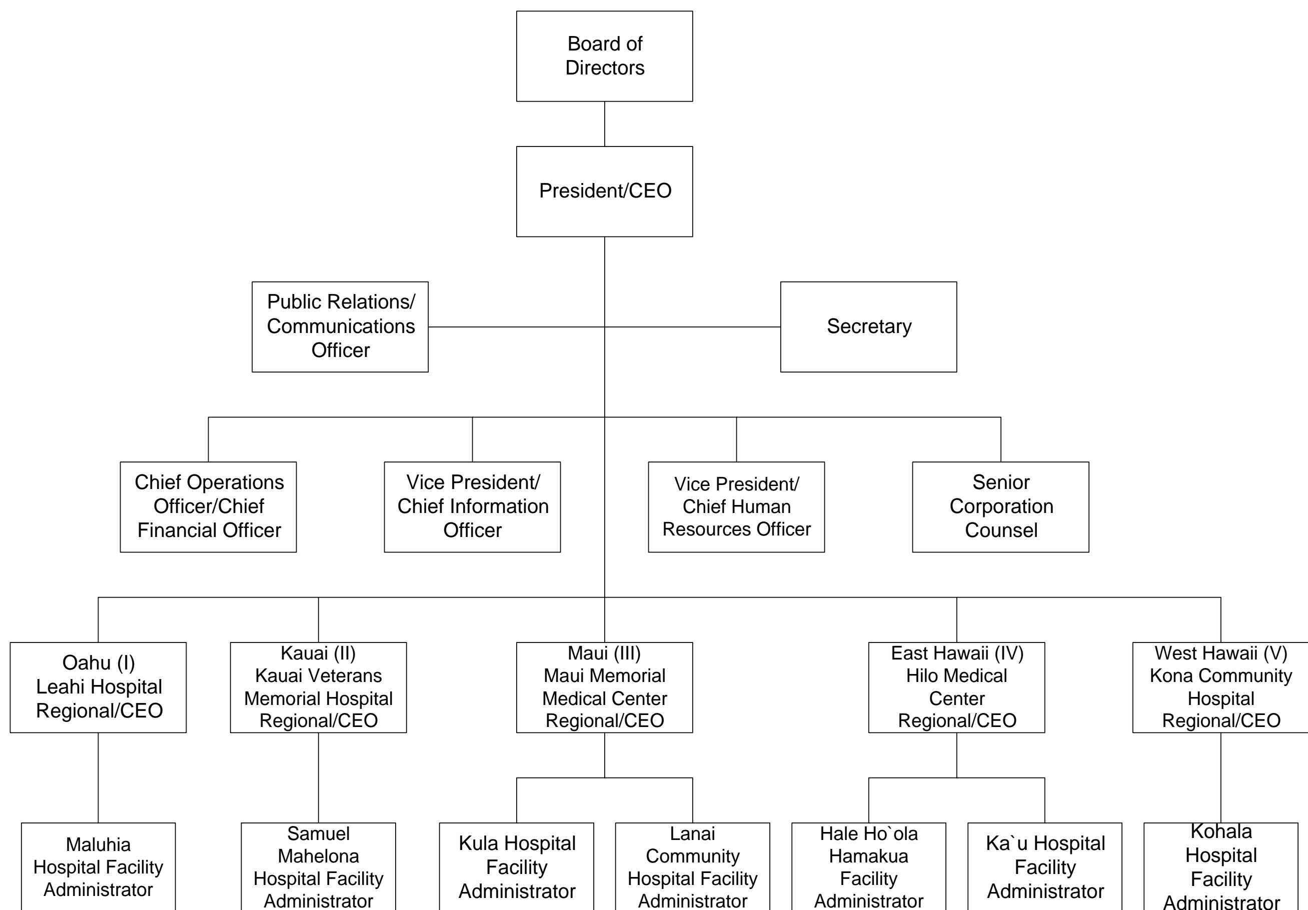
The corporation is governed by a 13-member board of directors consisting of the director of health, ten governor-appointed members, the chair of the public health facility management advisory committee, and a regional physician.

Today, the corporation operates 12 public hospitals and health facilities on five islands (Oahu, Hawaii, Maui, Kauai, and Lanai) and is one of the

largest public health systems in the country. As shown in Exhibit 1.1, the 12 hospitals are further divided into five regions, each managed by a chief executive officer under the overall management responsibility of the corporate president and chief executive officer.

The corporation has about 3,200 employees and operates more than 1,200 beds. Services provided include critical/acute inpatient care, skilled and intermediate nursing care, and ambulatory outpatient care. Many facilities also provide radiology, pharmacy, dietary, and laboratory services. Mental health services, as well as occupational, physical, recreational, and speech therapy services, are also available at some of the corporation's hospitals.

Exhibit 1.1
Organization of the Hawaii Health Systems Corporation



Source: Hawaii Health Systems Corporation

The corporation has established two subsidiaries, Hawaii Health Systems Foundation and Ali`i Community Care. The foundation is a statewide fund-raising organization for the corporation's programs while Ali`i Community Care provides assisted-living facilities throughout the State. Currently, the community care organization operates a 114-bed facility on Maui.

Revenues and expenditures

The corporation has depended on subsidies from the Legislature for both operations and improvements to hospital infrastructure since its inception.

The corporation's special fund generally covers between 89 and 96 percent of its total operating expenditures. The State's general fund subsidy has ranged from $8.2 million to over $29 million, which is between 4 and 11 percent of the corporation's total appropriation.

During the first six years of the corporation's existence, general fund subsidies amounted to $102.4 million, plus another $3.1 million in interest on capital improvement project (CIP) funding. (CIP funding is used for government projects with extended life spans, such as buildings, and is financed through general obligation bonds paid by the State.) The corporation's CIP funding totaled $60 million in FY2002-03, with more than half—$38 million—designated for expansion of the Maui Memorial Medical Center. Exhibit 1.2 shows the extent of the corporation's fiscal dependence on the State.

The Legislature also authorized the corporation to raise a total of $106 million in revenue bonds. (Revenue bonds are used to finance projects that generate their own revenue. The bonds are both secured by and paid off from this revenue.) The Department of Budget and Finance, however, determined that the corporation has insufficient revenue to justify such bonds so the corporation has not utilized this funding method.

The corporation administers a "safety-net" hospital system

The corporation's function as a "safety-net" hospital system for the people of Hawaii contributes to its fiscal challenges.

"Safety-net" hospital systems are identifiable by their commitment to provide care without regard to patients' financial or insurance status. Such hospitals provide significant levels of care to low-income, uninsured, and vulnerable populations. Consequently, "safety-net" hospitals receive a large portion of their revenue from federal Medicare and Medicaid programs. These programs, however, reimburse at rates that do not cover the cost of providing these services.

Exhibit 1.2
Program Appropriations and Other State Subsidies, FY1997-98 through FY2002-03

		State Subsidies						
Fiscal Year	Special Fund	General Fund Appropriations	Emergency Appropriations	Collective Bargaining	Interest on GO bonds**	Subsidies as % of Total	Total	CIP**
1997-98	$218,431,089	$8,000,000	$5,000,000	---	$67,927*	6%	$231,499,016	$1,364,000
1998-99	225,552,744	8,000,000	---	---	227,437*	4%	233,780,181	4,567,000
1999-00	235,409,387	7,750,000	20,500,000	---	68,923*	11%	263,728,310	1,384,000
2000-01	239,123,387	13,000,000	---	---	73,804*	5%	252,197,191	1,482,000
2001-02	246,519,978	2,000,000	5,000,000	$6,357,578	345,313	5%	260,222,869	6,934,000
2002-03	246,637,937	14,000,000	---	12,774,748	2,381,176	11%	275,793,897	44,327,000
Total	$1,411,674,522	$52,750,000	$30,500,000	$19,132,362	3,164,580	7%	$1,517,077,724	$60,058,000

* Interest amount was not available, these numbers are estimates based on 3.98 percent interest.

** The corporation does not pay for interest and principal on the general obligation bonds (GO bonds) issued by the State on the corporation's behalf. The related interest expense is included under the column heading "Interest on GO bonds."

*** Capital Improvement Projects (CIP) are funds raised through general obligation bond issues for projects with extended lives, such as construction of buildings.

Source: Legislative budget bills for FY1997-98 through FY2002-03.

Operating losses are widespread among the corporation's hospitals

Revenues from 11 out of the corporation's 12 hospitals did not cover FY2001-02 operating expenditures. State subsidies of $13.2 million only partially covered the total loss of over $29.9 million. Even with $2.3 million in income from other sources (such as contributions and interest), the corporation lost more than $14 million in FY2001-02.

Appendix A shows the discrepancy between expenditures and revenues, shown by outpatient, inpatient, and long-term care services for each of the corporation's hospitals during FY2001-02. Outpatient services are those that do not require admission to a hospital and allow patients to return home the same day. Inpatient services require patients to remain hospitalized at least overnight. Long-term care involves hospitalization in excess of 25 days due to a patient's inability to perform necessary life functions; disabled and aged persons are examples of typical long-term care patients.

Appendix A also shows each facility's occupation rate as a percent of available bed days and the profit or loss per bed per day. This information illustrates that occupancy rate is not a reliable indicator of

profitability. For example, long-term care facilities uniformly show deficits despite occupancy rates of close to 100 percent.

Similarly, rural neighbor island facilities that provide acute care, such as Kauai Veterans Memorial, Kohala, and Ka‘u Hospitals, tend to have larger losses per bed per day although other facilities have lower occupancy rates. For example, Kohala Hospital incurred a $1,355 loss for every day a bed was occupied in FY2001-02; Kauai Veterans Memorial Hospital was a close second with a daily per bed loss of $1,146.

In contrast, Hilo Medical Center, the corporation’s largest money loser, had a per bed per day loss of only $242—but it resulted in an operating loss of $14.9 million in FY2001-02. Maui Memorial Medical Center was the only hospital that covered its costs, making an operating profit of just over $3.5 million.

Current reimbursement levels for government-funded health services

Government-funded reimbursements have a significant impact on hospital revenues and on the corporation’s finances as a whole. Sixty percent of the corporation’s total revenue comes as reimbursements for health services through government programs. Of this, Medicaid payments for services represented 26 percent, Medicare accounted for 28 percent, and Hawaii’s QUEST program for 4 percent of total reimbursements received during FY2001-02. Exhibit 1.3 shows the disparity between non-government and government reimbursements compared to the cost of services provided.

As illustrated above, government reimbursements do not cover the cost of services to that group of patients. According to the corporation’s FY2001-02 reimbursement data, government-insured patients incurred a reimbursement shortfall of over $46 million. In contrast, the corporation gained more than $14 million in profit from services provided to patients who were covered by non-government payers, including the local health insurance carriers of HMSA and Kaiser.

Funding shifts affect the corporation’s dependence on state subsidies

The corporation’s financial dependence is also affected when funding shifts between government programs. An example of such a shift is the absorption of federal disproportionate share hospital (DSH) funding by the State’s QUEST health care program. DSH funding is intended to be an adjustment for non-reimbursed care to under- and uninsured patients. In most states, DSH funds are paid directly to hospitals serving a high

Exhibit 1.3
Non-Government versus Government Reimbursements, FY2001-02

Reimbursement Source	Reimbursements Received	Cost of Services Provided	Net Proft/ (Loss)	Percentage of Cost Reimbursed	Revenue as Percentage of Total	Cost as Percentage of Total
Non-Government	**$97,420,328**	**$83,301,387**	**$14,118,941**	**117%**	**40%**	**30%**
Medicaid	62,077,409	79,923,019	(17,845,609)	78%	26%	29%
Medicare	68,017,771	88,925,079	(20,907,308)	76%	28%	32%
QUEST	10,086,658	16,948,465	(6,861,807)	60%	4%	6%
Other Government	4,051,825	5,108,622	(1,056,797)	79%	2%	2%
Government	**$144,233,663**	**$190,905,184**	**$(46,671,521)**	**76%**	**60%**	**70%**
TOTAL	**$241,653,991**	**$274,206,571**	**$(32,552,580)**	**88%**	**100%**	**100%**

Source: Hawaii Health Systems Corporation

proportion of such under- and uninsured patients. QUEST is a state-administered Medicaid program providing health coverage for up to 125,000 lower-income residents, who would otherwise lack health insurance.

Disproportionate share hospital funding in Hawaii, which amounted to $30 million in 1994, has been absorbed into the QUEST program to pay premiums for individuals covered by the program. In addition to hospital services, QUEST premiums cover services from a wide range of other providers. Therefore, only a portion of the DSH funding now finds its way to the hospitals DSH is supposed to help. Although the funding shift allowed QUEST to provide health insurance coverage to a greater number of people, it has also increased the corporation's dependence on legislative appropriations to cover hospital shortfalls.

Furthermore, the QUEST program covers only 60 percent of the total cost of the services provided. Childbirth and mental health services are obvious examples where QUEST reimbursements fail to cover the cost of hospital services the corporation is required to provide. According to a hospital administrator, QUEST pays $1,750 per child delivery although this service costs the hospital about $4,200; and inpatient mental health care, which costs hospitals over $900 a day, is reimbursed at only $580 per day.

Federal reimbursements expected to continue falling

Medicare and Medicaid reimbursement shortfalls also contribute to the corporation's financial concerns. Such shortfalls and the resulting

increasing dependence on local financial support are a common problem for “safety-net” hospitals nationwide.

According to the National Association of Public Hospitals (NAPH), in 2000, Medicare reimbursements covered only 69 percent of the cost of services provided while Medicaid covered 74 percent. Hawaii’s corporation, a NAPH member, has fared slightly better than average: it received 76 and 78 percent, respectively, from Medicare and Medicaid reimbursements in FY2001-02.

NAPH also reports that losses from Medicare and Medicaid may worsen. This is due in part because Medicare’s cost reimbursements declined by 5 percent between 1999 and 2000 for NAPH member hospitals. With the cost of medical care increasing and no significant federal relief anticipated, “safety-net” hospitals—including the corporation—will be forced to depend even more on state support.

Anticipation that the corporation’s dependence on legislative subsidies will decrease is, therefore, unlikely to be realistic in the foreseeable future. As previously stated, the Legislature has subsidized between 4 and 11 percent of the corporation’s costs in recent years. Despite this, the corporation is less dependent on state funds than its “safety-net” hospital peers nationwide, which rely on state taxpayers for an average of 18 percent of their annual costs.

Previous audits

We have conducted five audits and studies on the State’s hospital system since 1988. Since the creation of the corporation, we have issued two reports, which are discussed below.

In the *Audit of the Hawaii Health Systems Corporation*, Report No. 99-09, we reported weaknesses in the corporation’s planning and implementing of cost-effective procurement policies and in its information system. Recommendations included establishing and applying formal, system-wide accounting procedures; and strengthening procurement procedures by analyzing expected benefits and outcomes, properly documenting personal services contracts, and monitoring and ensuring compliance with procedures.

In the *Follow-Up Study of the Hawaii Hospital Systems Corporation*, Report No. 02-09, we recommended the corporation’s Board of Directors make it a priority to establish procurement policies consistent with the goals of public accountability and procurement practices. Recommendations included that corporate management improve controls over contract expenditures; compliance with procurement and

contracting policies; processes for selecting vendors and for establishing, administering, monitoring, and evaluating contracts; and the creation of audit trails for all purchases.

Objectives of the Audit

1. Assess the corporation's management controls over its procurement, human resources, and financial management processes.

2. Assess the impact of federal reimbursements on the corporation's fiscal condition.

3. Make recommendations as appropriate.

Scope and Methodology

The audit focused on the Hawaii Health Systems Corporation's program and fiscal operations from its inception in FY1996-97 to the present. We examined the corporation's efforts to address recommendations from Report No. 02-09, *Follow-Up Study of the Hawaii Health Systems Corporation* to the extent that they related to our current objectives.

Audit procedures included interviews with board members, corporate management, and employees. We examined reports, records, and other relevant documents to assess the effectiveness of the corporation's controls in the areas of procurement, personnel, and financial management. We interviewed appropriate individuals from other agencies, including the departments of Budget and Finance and Human Services, and consulted with individuals and organizations with expertise in the hospital industry. Site visits and observations were conducted at Hilo Medical Center, Kona Community Hospital, Maui Memorial Medical Center, Leahi Hospital, and Maluhia Hospital. We observed processes, conducted interviews, and reviewed documentation relating to procurement, personnel, financial management, and infrastructure improvement issues at these five sites.

We also reviewed the corporation's compliance with pertinent state and federal laws, rules, and regulations, and state and corporate policies and procedures.

Our work was conducted from June 2003 through October 2003 in accordance with generally accepted government auditing standards.

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Chapter 2

Although Some State Subsidy Is Expected, the Hawaii Health Systems Corporation Has Not Prudently Expended State Funds

Expectations of self-sufficiency for the Hawaii Health Systems Corporation will be difficult to meet for the foreseeable future. There are two basic reasons why the corporation is unlikely to become self-sufficient: the first affects all "safety-net" hospitals' bottom lines, which is a lack of sufficient federal reimbursements to cover the cost of services. The second reason, and main focus of this audit, is that despite problems of insufficient federal reimbursement, the corporation has not done its best to handle state assets in a prudent manner. We found that the corporation has poorly managed its procurement practices by awarding multi-million dollar contracts without competition and using costly and questionable hiring practices. In addition, the corporation's problematic use of lease transactions may force an increase in state subsidies and further obligate the State.

Summary of Findings

1. The Hawaii Health Systems Corporation's poor procurement practices increase its dependence on taxpayers.

2. The corporation's use of lease financing circumvents legislative scrutiny and risks obligating the State.

The Corporation's Poor Procurement Practices Increase Its Dependence on Taxpayers

The Hawaii Health System Corporation's procurement practices are cause for alarm. Although reliance on some state subsidies is to be expected, weaknesses in the corporation's management of procurement add to its dependence on state funding. Primarily, the corporation has not embraced the State's commitment to open, competitive bidding and incurs unnecessary or unplanned costs in hiring independent contractors. The corporation has also awarded its top managers benefits that are uncommon in public sector employment.

The corporation awarded millions of dollars in contracts without competition

The corporation has not embraced the State's commitment to open, competitive bidding, but instead adopted procurement practices that clash with government accountability. Lenient policies and a lack of oversight facilitate discretionary contract abuses, resulting in millions of dollars in non-bid contract awards. This long-standing problem was also

identified in our two most recent audit reports. We also found a business venture with a contractor that raises questions about self-dealing.

Corporate policies conflict with the State's procurement principles

The corporation's interpretation excepting it from the State's procurement code is questionable, and its resulting procurement practices are inconsistent with government accountability. Legislative clarification, however, is needed to determine the applicability of procurement law relating to purchases of health and human services.

Executives and board members contend that the corporation's procurement procedures are modeled after common practices in the private sector, including hospitals. They assert these practices are consistent with those of a corporation (as opposed to a government agency) and have worked well, saving the corporation millions of dollars. They further maintain that these practices are justified by the corporation's statutory exemption from Chapter 103D, Hawaii Revised Statutes (HRS), the Hawaii Public Procurement Code.

The corporation's position is that Act 262, Session Laws of Hawaii (SLH) 1996, which established the corporation, intended it to provide better health care for everyone in the State by freeing public hospital facilities from unwarranted bureaucratic oversight. Specific exemption from the state procurement code is seen as an important part of this freedom.

Although the corporation is not bound by Chapter 103D, the Legislature has provided it with clear guidelines for managing procurement.

First, the Legislature clearly signaled its intent and goals for public procurement in the preamble to Act 8, SLH 1994, which established the State Procurement Code, by stating that:

> "It is the policy of the State to foster broad-based competition. Full and open competition shall be encouraged...Therefore, it is the legislature's intent to maintain the integrity of the competitive bidding and contracting process...."

Second, through Section 323F-7(a)(30), HRS, the Legislature gave the corporation the power to develop procurement policies and procedures "consistent with the goals of public accountability and public procurement," thereby specifically encouraging adherence to the state procurement code when possible.

The corporation, however, has not followed these guidelines in establishing its procurement practices. Despite its arguments, open and competitive procurement processes do occur in the private sector. We found two local hospitals that use competitive procurement processes, one of which follows a highly formalized competitive procedure requiring varying numbers of bids or proposals depending on dollar thresholds. Documentation is also required for every step in this process.

Aggravating its departure from government practice, the corporation's management also interprets its procurement policies very broadly. For example, it is not concerned when justifications for discretionary procurement do not meet corporate procurement policy criteria. According to the corporation's director of materials management, there are "potentially immeasurable circumstances" justifying departures from the corporation's discretionary purchases policy.

Furthermore, the corporation's board recently loosened control over procurement significantly by allowing the corporate CEO to approve contracts for dollar amounts up to $500,000 (up from $200,000) and allowing the regional CEOs to approve contracts for dollar amounts up to $200,000 (up from $100,000) without board approval.

The corporation's self-proclaimed exemption from Chapter 103F is questionable

The corporation's contention that it is exempt from complying with Chapter 103F, HRS, needs legislative clarification. Chapter 103F guides purchases of health and human services and was created separately from Chapter 103D, HRS, to improve the process of purchasing health and human services from organizations and individuals. At a minimum, many of the corporation's discretionary contracts with independent contractors to directly serve patients meet the criteria of those governed by Chapter 103F, HRS. Such contracts may therefore place the corporation in violation of state law, which does not provide for a discretionary contract option.

The corporation, however, has declared itself exempt from Chapter 103F, HRS, on the premise that the Legislature intended to exempt it, but due to an oversight did not specifically state this in the chapter. The State Procurement Office does not share the corporation's viewpoint and maintains that applicable contracts should comply with Chapter 103F requirements.

Discretionary contract abuses inhibit competition

The corporation routinely awards contracts on a non-competitive, discretionary basis, which conflicts with the State's procurement principles. In addition, our review of files found that many contracts

had been automatically and non-competitively extended; discretionary contracts lacked justification; and poor administrative practices frequently resulted in contracts remaining unsigned until after services had begun. The results of our contract file review are shown in Exhibit 2.1.

Exhibit 2.1
Results of Contract File Review

Review criteria	Number of contracts reviewed	Contracts meeting review criteria	Percent of contracts meeting review criteria
Contract awarded on discretionary basis	30	20	67%
Discretionary contracts lacking documentation for bids or quotes	20	14	70%
Discretionary contracts lacking adequate justification	20	17	85%
Contracts with non-competitive extensions or renewals	30	17	57%

For contracts normally subject to formal bidding under standard government procedures, the corporation's procurement policies allow a discretionary purchase option if certain criteria are met. In permitting such discretionary purchases, the corporation departs from State procurement practices, which do not allow this option except for sole-source purchases. Further, the corporation's procurement policies do not limit the dollar amount that can be approved for discretionary contracts, although they generally require at least two quotes before a contract is awarded on a discretionary basis.

We found that not only had discretionary contracts become the option of choice, these contracts also routinely failed to meet the corporation's stated policies and procedures. Sixty-seven percent of the contracts we reviewed were discretionary, and, according to a regional manager, as many as 95 percent of all contracts are discretionary in at least that one region. Some discretionary contracts are for multi-million dollar amounts.

Lack of oversight contributes to the problem

Slack oversight encourages the proliferation of discretionary contracts. Corporate executives and the board routinely approve such contracts, despite their lacking adequate justification.

We reviewed 20 of the corporation's discretionary contracts. Of these, 85 percent lacked a justification meeting as required by the corporation's policy, and 70 percent had no documentation showing required quotes were obtained.

Justifications for avoiding a competitive bid frequently did not address the corporation's established criteria, which allows discretionary contracts when an emergency arises (where time is of the essence in establishing the contract); there is a lack of other providers; the complexity of the contract's characteristics is beyond the corporation's expertise; and a more favorable negotiation of an existing contract can be made.

Only a few of the corporation's contracts met these criteria. Examples of inadequate justifications included: "the contractor is able to provide the services and is a local resident"; "acute shortage of therapists"; and "the contractor has developed other programs for the facility." The corporation's CEO even approved two contracts that lacked adequate justification.

Although the discretionary contracts we identified represented only 7 percent of the corporation's open contracts, they made up at least 43 percent of their total dollar volume. However, the corporation's contract database does not track how contracts are procured; therefore corporate-level awareness of the overuse of discretionary contracting appears to be minimal or downplayed.

Automatic extensions are widespread

Automatic and non-competitive renewals or extensions of contracts are also widespread. More than half (57 percent) of the contracts in our sample were renewed without bid. Including extensions, these contracts amount to over $6 million.

For example, a service contract with a doctor was renewed annually over a five-year period and then extended for two years. Similarly, contracts for courier services and pest control that are in force continuously for at least three years effectively operate indefinitely.

Non-bid contract renewals provide no assurance that the corporation has obtained the best possible business arrangement, and they create the impression that expedience has a higher priority than preserving the corporation's resources. They are also inconsistent with the Legislature's desire in establishing the State procurement code, which is "to maintain the integrity of the competitive bidding and contracting process by discouraging the State and counties from making changes once the contracts are awarded."

Poor contract administration is also evident from the number of contracts signed after services have begun. Fifty-three percent of the contracts we reviewed were signed as many as seven months (217 days) after their effective date. In several instances, services were rendered and bills even paid before a valid contract existed. By allowing services to be performed in the absence of a signed agreement, the corporation incurs unnecessary legal risks if problems or disputes arise.

Non-bid, multi-million dollar contract raises concerns over potential conflict of interest

Even the corporation's multi-million dollar contracts, among the largest deals with providers, are often awarded without bid. We also discovered a potential conflict of interest where the corporation formed a business relationship with a long-standing contractor.

Clinical Laboratories of Hawaii, Inc. (CLH-Inc) has had a contractual relationship with the corporation since at least 1994. In 1997, CLH-Inc was the successful bidder for the corporation's statewide laboratory services contract. Over the next six years, this contract was extended non-competitively six times. The initial two-year agreement for $20 million ultimately became a six-year contract for just under $60 million.

In April 2002, the corporation, CLH-Inc, and two other parties formed a joint venture called Clinical Laboratories of Hawaii, LLP (CLH-LLP). The corporation appointed its own chief financial officer as its representative on the joint venture's governance committee. Then, in July 2003, a $45 million, non-competitive contract for statewide laboratory services was established with CLH-LLP.

The award raises concerns for several reasons. First, files for the contract do not show proper approval and justification for this discretionary agreement nor evidence that quotes or proposals were sought or considered, as required by the corporation's procurement policy.

More importantly, awarding the non-bid contract to CLH-LLP, in which the corporation owns a minority equity interest, raises conflict of interest concerns because the award could be construed as a form of self-dealing or preferential treatment.

The State Ethics Commission has cautioned that, where a government official is on the board of a contractor receiving non-bid contracts, competitors may perceive that preferential treatment was given because the official served on the contractor's board. To prevent an appearance of impropriety, the commission advises applying measures that demonstrate contracts have been awarded fairly. The corporation,

however, has failed to do this in awarding its contract with Clinical Laboratories of Hawaii, LLP on a discretionary basis.

The corporation's procurement of personal services is costly and questionable

We found that the corporation's hiring practices increase costs, risk substantial liabilities and penalties; and may violate payroll tax laws and the State's Fair Treatment Standards. Certain practices also raise questions about the compatibility of corporate practices and government accountability.

Expensive independent contractors were hired to perform essentially the same functions as lower-paid employees. Some of these contracts illustrate an award process that emphasizes convenience over competition. Corporate officials have justified the contracts as addressing emergencies that, upon closer inspection, could have been avoided by proper planning. Furthermore, misclassified independent contractors may expose the corporation to substantial tax liabilities and penalties, and corporate perks to management-level employees are difficult to reconcile with government accountability.

Hiring of expensive independent contractors lacks justification

The corporation has hired numerous expensive independent contractors to perform essentially the same functions as those of lower-paid employees. Together, these contracts provide a strong impression that the corporation favors convenience over accountability and cost containment. Such contracts include 1) a dialysis nurse who was paid a $250,000 to establish dialysis services at Maui Memorial Medical Center; 2) lobbyists who were paid between $100,000 and $150,000 per year over the last five years; and 3) several contractors who performed regular employees' functions for as much as four times the cost of an equivalent employee.

The Maui Memorial Medical Center contract with the dialysis nurse was the result of a self-imposed emergency situation due to poor planning. When the center's kidney specialists limited the number of patients admitted to Maui Memorial Medical Center because the short-staffed contractor for inpatient dialysis services was unable to meet patients' needs, the state agency responsible for planning and approving new and expanded health services mediated a solution. The contractor would limit its services to providing outpatient dialysis and the center would take over the provision of inpatient dialysis.

However, preparations for the Certificate of Need required to establish in-patient services was hastily scheduled for completion within a month of the agreement. As the center found itself short of time for

competitively recruiting the highly specialized staff needed for this task, it resorted to procuring a high-priced contract with one of its doctors' former co-workers from the mainland.

The resulting $250,000 paid over 15 months for work comparable to that of an employee was unnecessarily costly. In Hawaii, annual salaries for top-level registered nurses with management responsibility generally range from about $91,500 to $147,000.

This example raises questions not only of the corporation's commitment to preserving its resources, but also of a possible violation of the State's Fair Treatment Standards. Section 84-13, HRS, forbids employees from using, or attempting to use, their official position to secure or grant unwarranted privileges, exemptions, advantages, contracts or treatment for themselves or others.

The issue of highly paid contractors performing functions normally handled by employees also arose from the corporation's use of professional lobbyists. The corporation spent between $100,000 and $150,000 per year over the last five years for lobbying services. Although state agencies generally need to plead their case before the Legislature, most accomplish this without outside contractors.

The corporation attributed its use of lobbyists to advice from the community-based management advisory committees. According to its CEO, the corporation "lives and dies by the Legislature," which changes every two years. Although the CEO had approached legislators himself with little impact, he said lobbyists' involvement made legislators more accessible and receptive to meeting with him during the legislative session. The CEO also said the corporation's board had anticipated that hiring lobbyists would attract criticism, but approved their use as long as it was legal, ethical, and necessary.

This same principle apparently guides the rest of the corporation's dealings with independent contractors. The following examples dispel any notion that independent contractors are a low-cost alternative to hiring employees. In one instance, an independent contractor was paid $17,300 per month to serve as an accountant, a rate nearly four times higher than a comparable employee's total monthly compensation (including benefits) of $4,534 per month. Another example is an independent contractor who was hired for a wound care program and paid $73,309. The equivalent employee position started at $67,353 (including benefits)—9 percent lower than the contractor's fee. Moreover, two contractors were paid more than the salary and benefits of the employees supervising their work: A retired employee was rehired as an independent contractor to work as a procurement analyst at $8,000 a month—19 percent greater than the salary and benefits earned by the

same person as an employee and 14 percent more than her supervisor's salary and benefits. Another contractor, a physician, was paid $180,000 annually—29 percent higher than the employee supervising his work.

Misclassified independent contractors may expose the corporation to large penalties and liabilities

Contractors who are misclassified as "independent" expose the corporation to a number of risks. Substantial liabilities for taxes and penalties from the Internal Revenue Service (IRS), lawsuits from the misclassified contractors for retroactive employee benefits, and possible violations of state law prohibiting the corporation from entering into contracts that effectively replace employee positions or responsibilities.

Internal Revenue Service (IRS) rules require that independent contractors be able to control the means and methods of accomplishing the results of services they are hired to perform. Generally, the more control a hiring entity has over what, how, and when services are performed, the more likely an employer-employee relationship exists. While employers are required to abide by state and federal payroll withholding laws, such tax withholdings are not required from payments to independent contractors.

Using criteria developed by the IRS, we tested 19 of an estimated 108 contracts the corporation holds with independent contractors. The criteria are grouped into three categories. Each category supports the existence of an employer-employee relationship if a strong indication of employer control is found. They are:

1. Behavioral control—facts demonstrating a right to direct how a worker performs specific tasks, including instruction and training;

2. Financial control—facts demonstrating a right to control business aspects of a worker's activities, including unreimbursed expenses, services made available to clients, and the opportunity to make a profit or loss; and

3. Relationship control—including employee benefits, a relationship's permanency, and work performed as a part of regular business activities.

We found that 18 out of 19 contracts (95 percent) met criteria in all three categories, indicating a strong potential for an employer-employee relationship. This places the corporation at a high risk for substantial liabilities for back-taxes, penalties, and litigation due to misclassified independent contractors.

Such liabilities can and have been imposed on government-type employers, not just private sector companies. Independent contractors later deemed employees by the IRS have successfully sued for employee benefits such as vacation, sick leave, and pensions. Some cases have resulted in million dollar awards, including a county government's $24 million settlement with long-term temporary workers whom the IRS determined had been improperly classified as independent contractors.

The corporation can determine whether an individual is an employee by obtaining Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, from the IRS. Industry experts also recommend that employers establish a compliance plan that includes a method of analyzing the proper classification of all potential independent contractors and a documentation system for all confirmed independent contractors.

Additional violations of state and federal laws may arise from misclassifying independent contractors. For example, hiring contractors to do the work of employees may contravene the corporation's enabling statute. Section 323F-7(33)(c), HRS, states in part:

> The duties and powers granted to the corporation may not be used to enter into contractual or business relationships which have the practical effect of allowing private sector counterparts to replace employee positions or responsibilities within the corporation or its facilities.

Many of the functions performed by the corporation's independent contractors are similar or identical to those of regular employees and therefore may amount to replacing existing employee positions.

Furthermore, the federal Immigration Reform and Control Act requires that employers verify the eligibility and identity of all employees and complete an Immigration and Naturalization Service Form I-9 for each person hired. The distinction between an independent contractor and an employee is based on factors indicating control, similar to the criteria developed by the IRS. Experts recommend that an I-9 form be completed for any independent contractor that could be perceived to be an employee equivalent to avoid inadvertent violations. We did not find any I-9 forms in the contract files reviewed.

Corporate officials reported that although the corporation did not have a policy to address the proper classification of independent contractors versus employees, it was in the process of developing one. Until then, the corporation remains exposed to legal and financial risks from the misclassification of independent contractors.

Perks for top managers are uncommon in government

Section 52, Chapter 26, HRS, statutorily caps salaries for state department heads and executive officers at $85,302 per year. The only additional benefit allowed is a $3,600 annual car allowance. As at-will employees, state department heads are not eligible for reduction-in-force (RIF) rights should their positions be eliminated by department restructuring.

In contrast, the corporation's top officials receive almost triple the salaries of their state counterparts, plus benefits and incentive pay that are not available to other exempt employees. Also in contrast to exempt state employees, corporation officials' employment contracts contain RIF rights and individually negotiated severance payments should they be terminated in a corporate restructuring.

The corporation CEO's $255,000 annual salary is almost three times higher than that of state department heads. By comparison, this salary is, however, more in line with Hawaii's private hospital executives. Based on non-profit tax filings, private hospital executives' salaries, excluding perks and benefits, range between $218,969 and $601,996.

With 12 hospitals on four islands, over 1,200 beds, and 3,400 employees, the corporation's operations are comparable in size and complexity to some of the largest private hospitals in the state. The corporation CEO's salary falls within the range paid to private-industry counterparts, but is dramatically higher than state agency executive officers'. The higher salary is further supplemented by an annual housing allowance of $45,000, individual life insurance premiums, an annual cost of living increase (waived in recent years), and $1,260 for an annual private club membership from the corporation's protocol fund.

In addition, to augment managers' basic salaries, the corporation instituted an incentive compensation program with bonuses of up to 50 percent of employees' salaries. Between FY1999-00 and FY2001-02, managers earned more than $768,000 in incentives. The program was suspended after FY2001-02, following which incentives were neither earned nor paid out. Although this suspension effectively ended the program, it was not officially discontinued by the Hawaii Health Systems Corporation board until July 1, 2003. About $352,500 is still owed to employees who previously earned incentives; currently, the only way to collect the incentives is to leave the corporation.

Corporate officials acknowledge that the program has attracted negative attention, as legislators questioned how the company could afford to pay incentives while requesting additional funding.

Corporate executives are also under a termination agreement that provides the equivalent of one month to two years' salary (based on position and years of service) if the corporation were to reorganize. Actual severance entitlements by employee are shown in Exhibit 2.2.

Exhibit 2.2
Severance Payment Amounts by Position

Eligible Participants	Number of Months' Salary
Corporate Chief Executive Officer	24 months
Corporate Chief Financial Officer	12 months
Regional Chief Executive Officer	12 months
VP/ Chief Information Officer	12 months
VP/General Counsel	12 months
VP/Director of Human Resources	12 months
Hospital Administrators, Regional Chief Financial Officers, and Assistant Hospital Administrators	1 month per year of service; 6-month maximum

Source: Hawaii Health Systems Corporation

Apart from this termination agreement, some exempt employees have also received the equivalent of six months' salary—more than $40,000 each—under a confidential settlement agreement. Unlike termination agreements, settlement agreements do not have specific criteria defining settlement amounts. Such agreements are often used to avoid the expense of potential legal actions and are negotiated with employees or their attorneys. Settlement agreements are another benefit not available to exempt employees at other state government agencies.

The incentive program was considered a "pay for performance" tool that would help the corporation "attract, retain and motivate quality employees." Severance payments are intended to provide people with some comfort that there would be provisions in the event of organizational changes. Confidential settlement agreements are used to resolve any controversies between individuals and the corporation, such as those involving collective bargaining agreements, civil rights agency proceedings, civil suits, or contested terminations.

In contrast, state department heads, as exempt employees, are not entitled to reduction-in-force (RIF) rights. State department heads are also employed at-will and can be dismissed without any severance benefits. Under the Civil Service Reform Act (Act 253, SLH 2000), exempt

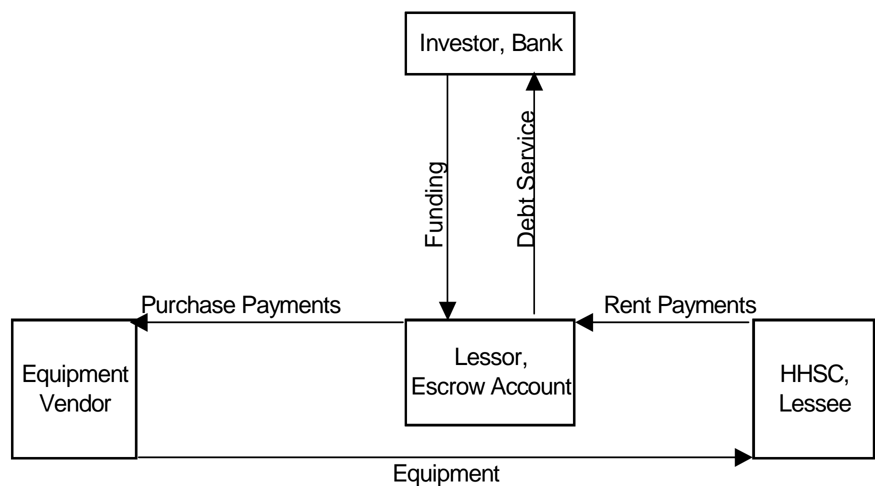
employees can receive compensation under department reorganizations only if they retire from the state system completely.

The Corporation's Questionable Use of Lease Financing Circumvents Legislative Scrutiny and May Further Obligate the State

The corporation uses municipal leases as a way to raise money for equipment and infrastructure improvements. Municipal leases do not require legislative approval nor affect the State's debt ceiling; however, the apparent advantage of being able to raise debt funding without regard to borrowing constraints is deceptive: If the corporation is unable to make required lease payments, the State's commitment to providing health care services may obligate the Legislature to fund the corporation beyond intended levels.

Municipal leases offer private investors low, but tax-advantaged, interest earnings. Lessees, like the corporation, pay lower interest rates than those for comparable commercial leases. The corporation utilizes municipal financing leases, which in effect operate like bank loans. Investors, represented by a lessor, provide funds that finance the corporation's equipment or infrastructure improvement projects. Although the corporation legally owns the leased assets, a security interest remains with the lessor until all lease payments are made. Exhibit 2.3 illustrates the relationships and parties involved in a lease deal.

Exhibit 2.3
Description of the Inter-Relationships in a Lease Arrangement



Source: Hawaii Health Systems Corporation

The corporation has already committed itself to over $53 million in municipal leases to pay for equipment purchases, infrastructure improvements, and services expansions. Such projects included construction projects, such as a $2.5 million extension at the Kona Community Hospital to accommodate a nuclear imaging unit. Another $50 million may be committed if energy conservation and generation projects for up to nine hospitals are carried out as originally projected. Although municipal leases do not affect the State's debt ceiling, which is statutorily restricted, the Legislature has no opportunity to examine and scrutinize these municipal leases because they fall outside the legislative budget approval process.

Unscrutinized leases may impair the Legislature's control over appropriations

Because the corporation is authorized by law to raise its own capital funds and its leases are its own, not the State's, legal liability, its municipal leases are not subject to the legislative budget approval process. However, should the corporation default on these leases, the Legislature may find itself obliged to provide funding to ensure medical services continue uninterrupted and hospitals remain open.

The Legislature therefore has a direct interest in projects financed through municipal leases. The corporation, unable to cover its expenditures without legislative appropriations, depends on the Legislature to pay for these lease obligations. The corporation even uses projected appropriation amounts in planning new leases. On this ground, the Legislature should be fully informed of all lease obligations that the corporation incurs or plans to incur.

The corporation's municipal lease contracts do contain a non-appropriation clause, which releases it from lease obligations if appropriated funds are insufficient to make required payments. The corporation would then be obliged to return the leased assets or cease using them. Hospital operations could be jeopardized if the clause were invoked for equipment essential to a hospital's operations. The lease contract for financing the Kona nuclear imaging unit's construction, for instance, requires the corporation to surrender to the lessor the leased property if appropriations are insufficient to make the required payments. Under this contract, therefore, the lessor has a security interest in a portion of the hospital building.

Despite its massive need for capital, the corporation does not have a comprehensive, long-term capital-spending plan for the entire hospital system. Such a plan, as part of a strategic plan, would be a valuable tool for the Legislature in assessing the corporation's borrowing needs, timing thereof, and potential effect on the state purse. Unlike the corporation, at least one major local hospital prepares a comprehensive ten-year, long-term capital-spending plan.

Exhibit 2.4 summarizes the corporation's current and past municipal lease transactions. Between FY1999-2000 and FY2002-03, the corporation paid more than $15 million in principal and over $5 million in interest. On currently active leases, the corporation will pay an additional $38 million in principal and $9 million in interest for its municipal leases through the end of 2015.

Exhibit 2.4
Municipal Leases - Schedule of Principal and Interest Amounts by Fiscal Year

Fiscal Year	Principal	Interest
1998-99	$354,312	$122,246
1999-00	1,142,744	371,872
2000-01	2,575,190	813,124
2001-02	4,198,846	1,495,857
2002-03	7,197,463	2,506,296
Total Paid prior to 7/1/03	$15,468,555	$5,309,395
2003-04	7,414,554	2,180,668
2004-05	6,645,992	1,738,286
2005-06	5,913,570	1,345,649
2006-07	3,547,955	1,034,040
2007-08	2,353,702	850,477
2008-09	2,147,805	710,788
2009-10	2,199,216	574,885
2010-11	2,266,109	436,314
2011-12	2,147,364	294,691
2012-13	1,826,460	170,694
2013-14	1,702,287	57,931
2014-15	72,416	377
Current Leases as of 7/1/03	$38,237,430	$9,394,800
Grand Total All Leases	$53,705,985	$14,704,195

Source: Hawaii Health Systems Corporation/Academic Capital LLC lease schedules.

Lease obligations carry higher interest than general obligation bonds

Typically, state agencies finance capital improvement projects through general obligation bonds, which are debt instruments issued by the State. Capital improvement projects are acquisitions of assets with long useful lives, such as buildings. General obligation bonds generally have lower interest rates than municipal leases. The difference can result in significant savings in interest costs.

For example, the corporation's interest rate on a municipal lease agreement, primarily to finance a co-generation project at Kauai

Veterans Memorial Hospital is 6.20 percent. In contrast, the interest rates on general obligation bonds with comparable issue and due dates average 3.96 percent, 2.24 percent lower than that for the corporation's lease. This difference would save more than $600,000 in interest charges over the 12-year life of the $3.9 million lease.

Interest savings for a portfolio of $38 million in leases—the approximate amount outstanding as of June 30, 2003—would be an estimated $800,000 a year if general obligation bonds had been used.

As the corporation depends on state funding, financing its bonds at the lowest rate possible significantly benefits the State. The corporation should therefore seek legislative approval for financing through general obligation bonds to the extent possible. The corporation has received approval from the Legislature to raise capital improvement project funding through general obligation bonds in the past. As of June 30, 2003, $60 million have been approved, of which $38 million will be used for expansion of the Maui Memorial Medical Center.

General obligation bonds may not always be more suitable than municipal leases, because they are time-consuming and less flexible. However, if the corporation develops a long-term capital-spending plan, the Legislature would have the option of financing at least some capital improvement projects through general obligation bonds.

Non-bid master leases mushroom to $53 million

The corporation awarded an open-ended master lease agreement to Academic Capital LLC to raise funding through municipal leases. While the corporation's executives and board members maintain the award was made after substantial research to ensure a favorable deal, the corporation was unable to provide documentation indicating this agreement was awarded through a competitive process. Between 1998 and 2003, this contract has mushroomed into 57 separate lease schedules for a total of at least $50 million.

Subsequently, another open-ended lease agreement was awarded to Salem Capital Group, Inc., where the former president and chief executive officer of Academic Capital LLC took over the equivalent position. Again, the corporation was unable to provide evidence that the agreement was competitively awarded. So far, $3.6 million in leases have been awarded under this agreement.

Moreover, the corporation's entire $53 million lease-portfolio has been brokered through one individual who represents both leasing companies. Yet we found several local banks that broker municipal leases for Hawaii clients, including other local hospitals. At least one of these banks was

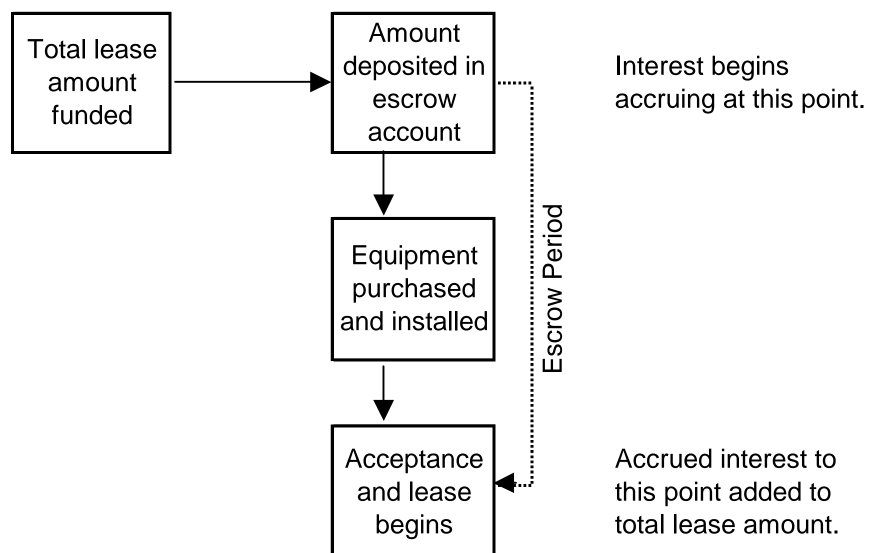
interested in the corporation's lease deals, but was not given an opportunity to compete.

Poorly planned lease acquisitions add unnecessary interest costs

As of August 31, 2003, the corporation has paid at least $300,000 in principal and $80,000 in interest for medical and support equipment that cannot be delivered because accommodations for the equipment require modifications. This could have been avoided with better planning. The corporation, however, has been paying for the $2 million equipment through municipal lease payments since at least November 2002.

In municipal lease transactions, interest charges typically accrue from the effective date of the lease, as shown in Exhibit 2.5. When equipment procurement and installation require time, an escrow period allows the lessee to make equipment operational before lease payments begin. Following the escrow period, accrued interest is added to the principal and paid off over the lease period. Unanticipated delays do not postpone payment obligations; as a result, poorly planned installations incur lease payment costs without the related use of the acquired equipment.

Exhibit 2.5
Timeline of a Lease Start-up



Source: Academic Captial LLC

Another delay due to planning deficiencies involves cart-washing equipment costing $136,000. Delivered in October 2002, the equipment

sat on the receiving hospital's delivery dock for over ten months. Faulty specifications, requiring compensatory modifications to hospital structures, prevented the equipment's installation. Yet lease payments for this equipment have been made since November 2002.

Hospital-level managers showed little sense of urgency to shorten such delays. They believed that, because the supplier of the equipment had not been paid, costs would not accrue. They were unaware that the corporation had already been making payments on the money raised to finance the equipment.

Fiscal needs projections are based on faulty data

Cost-benefit projections for planned projects have been seriously flawed.

For example, a new dialysis unit at Maui Memorial Medical Center incurred losses that were $320,000 greater than expected in the first full year of operation. In another case, a project to determine the feasibility of a nuclear imaging unit at Kona Community Hospital, the corporation's board was presented with an inept analysis that provided no assurance that the anticipated profitable result could actually be achieved.

Projected losses for dialysis unit grossly off-base

A new dialysis unit became operational at the Maui Memorial Medical Center in May 2002. The corporation originally projected the new unit would lose between $35,000 to $45,000 in its first full year of service (FY2002-03) at a volume of 75 to 120 services per month. The corporation's accounting records, however, revealed that the unit lost over $350,000 for the year within the projected volume range. As a result, $313,857 in revenues was outstripped by $669,921 in operating costs.

This illustrates the importance of accurate predictions. If a loss is incurred for every patient served, a new service will strain a hospital's resources even more. Ultimately, it is the Legislature that must appropriate funding to cover such additional losses as long as the corporation continues its fiscal dependence on the State.

Justification for nuclear medicine unit based on defective data

Another problematic cost-benefit analysis we found is a net present value calculation for the profitability of a nuclear medicine unit at Kona Community Hospital that was peppered with errors. Net present value calculations are a method of computing the desirability of a project by removing the effect of inflation from expected receipts and expenditures over a project's productive life. Assuming a dollar today is worth more than a dollar in the future, the value of future receipts and expenditures is

discounted using an appropriate inflation rate (typically an organization's interest rate on its borrowings).

The inaccuracies and faulty methodology that marred the net present value analysis for Kona Community Hospital's proposed nuclear medicine unit rendered it unreliable for decision-making. Despite corporate managers' acknowledgment that the analysis was inept, its conclusions were still presented to the corporation's board.

The net present value analysis for this $380,000 startup project contained a number of problems. For instance, it failed to include basic elements for a useful analysis such as all incremental costs and income over the useful life of the project. Outlays for installation, structural modifications, $26,000 for furniture, $72,000 for storage units, and upgrades needed during the evaluation period were omitted from the analysis. Furthermore, the net present value was calculated over periods of only five and ten years, which is less than the equipment's expected useful life; and the discount rate selected to compute the net present value had no relationship to the interest rate the corporation pays for its borrowings. Such omissions and errors could lead to erroneous conclusions and the anticipation of benefits that will not be realized.

Board members expressed concerns

Members of the board have acknowledged concerns about the quality of analyses and projections for expansion of service projects as well as the qualifications of those who prepared them. Yet although the board requires post-project evaluations to monitor the accuracy of analyses and predictions, it has not enforced the requirement. Board members explained that the corporation has only recently reached a state where financial management processes can be conducted in a proactive manner, allowing the planning and monitoring of capital improvement projects to be placed on a higher priority. However, in the absence of reliable information on which to base decisions and accountability for projections, new services could further increase the corporation's financial losses and add to the corporation's dependence on state subsidies.

Expensive capital inventories are poorly safeguarded

The corporation's leases include substantial amounts for capital equipment purchases (hospital equipment with an expected life exceeding one year). Hospital equipment can be very expensive so proper safeguarding processes are important to protect the corporation from unnecessary losses. We found that long-standing problems in this area continue.

The corporation relies on a disjointed hodge-podge of accounting systems to track its $300 million in capital assets. Inventory management lacks adequate, uniform standards and oversight to ensure that assets are properly accounted for and safeguarded. At three hospitals we visited, we found disparate inventory systems, a lack of proper segregation of critical accountability tasks, inaccurate or inadequate inventory records, and the need for a tagging system.

Disparate systems. Each hospital we visited has its own inventory tracking system. Some of these are inadequate, inefficient, or cumbersome. Examples include using the State's asset listing (although the corporation is no longer linked to the State's accounting system); and an awkward homemade system using at least 38 spreadsheets. The corporation's external auditors have alerted corporate managers to this issue for a number of years, yet the problem persists.

Lack of segregation of duties or compensating controls. The custodians of equipment at the corporation's hospitals are the same individuals who perform required periodic inventory counts. Generally accepted accounting principles require segregation of custodial and record keeping duties unless compensating controls, such as supervisory spot checks, are in place. This prevents individuals from committing and concealing mistakes or irregularities. Without such controls, the corporation cannot ensure its equipment is properly safeguarded and accounted for.

Inaccurate inventory and lost, unexplained, or undocumented missing items. At one hospital, the current inventory listing still includes allegedly discarded equipment units. However, the hospital could not provide documentation of these disposals. It was also unable to explain a missing refrigerator-size sterilizer.

Lack of equipment identification tags. One of the three hospitals we visited lacks a systematic way to identify, record, and track its equipment (such as with inventory tags). This deficiency is long-standing and has previously been reported to management by the corporation's external auditors. Best practices dictate that a unique tag, imprinted with a number, be attached to each equipment unit. The tag is recorded on an inventory listing and used to identify and track the unit.

Disjointed inventory systems perpetuate incomplete, inconsistent, and inaccurate records. As a result, management cannot ensure it has accurate and meaningful information for decision-making on capital asset investment. Furthermore, there is no assurance that equipment is sufficiently protected from abuse, waste, theft, or mismanagement.

Better oversight, centralized inventory systems, and uniform standards to account for equipment are needed to ensure the corporation's assets are safeguarded. At a minimum, every hospital should use a uniform tagging system and make certain that persons other than inventory custodians perform the inventory counts.

Conclusion

Persistent flaws in the corporation's procurement, personnel, and capital asset management increase costs and impair the corporation's ability to minimize dependence on state subsidies. Procurement practices that may be common in the private sector conflict with the Legislature's stated commitment to open, competitive procurement. The corporation's questionable lease financing also escapes legislative scrutiny and may further obligate the State.

Recommendations

1. The Board of Directors of the Hawaii Health Systems Corporation should:

    a. Ensure, through improved procurement policies and strengthened oversight, that the corporation's procurement practices are consistent with the goals of government accountability and procurement practices;

    b. Develop and implement policies for hiring independent contractors that ensure compliance with applicable state and federal laws;

    c. Reassess its termination and separation policies for consistency with government practices in light of the corporation's dependence on legislative support; and

    d. Establish and enforce accountability standards for both competence and reasonable accuracy in analyses and projections presented in support of investments in infrastructure and service additions.

2. The corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

    a. Implement and enforce procurement procedures consistent with open competitive procurement;

    b. Ensure that hiring, including contracts for personal services, comply with prudent business practices and applicable laws and regulations;

   c. Develop and maintain a long-term capital spending plan;

   d. Ensure that analyses and projections submitted for capital investments are performed competently and are accurate and complete;

   e. To the extent possible, identify and submit for legislative approval major infrastructure projects for financing via general obligation bonds; and

   f. Establish, at a minimum, uniform standards for accounting for and safeguarding capital assets.

3. The Legislature should:

   a. Clarify its intent regarding whether or not the corporation should be exempt from Chapter 103F, HRS; and

   b. As part of its budget review process, require the corporation to provide adequate information to evaluate plans to use municipal leases for financing infrastructure improvements and additions of new services.

Appendix A
Operating Results, Capacity, and Occupancy for Acute and Long-term Care by Hospital, FY2001-02

Maui Memorial Medical Center	Outpatient care	Acute care	Long term care	Total
Revenues	$ 18,159,090	$ 72,151,472	None	$ 90,310,562
Operating costs	16,004,208	70,758,069		86,762,277
Income (Loss)	2,154,882	1,393,403		3,548,285
Beds		214		
Occupancy rate		76%		
Income(loss) per bed day		$ 24		

Kula Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 96,521	$ 119,561	$ 10,138,350	$ 10,354,432
Operating costs	106,302	71,951	11,156,547	11,334,800
Income(loss)	(9,781)	47,610	(1,018,197)	(980,368)
Beds		2	113	
Occupancy rate		20%	97%	
Income(loss) per bed day		$ 320	$ (25)	

Lanai Community Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 200,485	$ 149,517	$ 748,934	$ 1,098,936
Operating costs	569,310	136,846	1,584,976	2,291,132
Income (Loss)	(368,825)	12,671	(836,042)	(1,192,196)
Beds		4	10	
Occupancy rate		4%	98%	
Income(loss) per bed day		$ 235	$ (235)	

Kauai Veterans Memorial Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 2,685,530	$ 3,746,991	$ 1,585,763	$ 8,018,284
Operating costs	4,084,843	6,929,091	2,139,461	13,153,395
Income (Loss)	(1,399,313)	(3,182,100)	(553,698)	(5,135,111)
Beds		25	20	
Occupancy rate		30%	96%	
Income(loss) per bed day		$ (1,146)	$ (79)	

Samuel Mahelona Memorial Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 116,577	$ 953,990	$ 5,447,682	$ 6,518,249
Operating costs	380,164	1,338,775	6,366,315	8,085,254
Income (Loss)	(263,587)	(384,785)	(918,633)	(1,567,005)
Beds		15	66	
Occupancy rate		28%	88%	
Income(loss) per bed day		$ (248)	$ (43)	

Hilo Medical Center	Outpatient care	Acute care	Long term care	Total
Revenues	$ 13,133,069	$ 39,443,898	$ 8,879,140	$ 61,456,107
Operating costs	15,873,188	50,070,086	10,415,849	76,359,123
Income (Loss)	(2,740,119)	(10,626,188)	(1,536,709)	(14,903,016)
Beds		153	108	
Occupancy rate		79%	96%	
Income(loss) per bed day		$ (242)	$ (39)	

Kona Community Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 9,749,225	$ 17,711,994	$ 2,949,077	$ 20,661,071
Operating costs	10,067,056	21,020,710	4,518,014	25,538,724
Income (Loss)	(317,831)	(3,308,716)	(1,568,937)	(4,877,653)
Beds		55	34	
Occupancy rate		76%	90%	
Income(loss) per bed day		$ (217)	$ (141)	

Hale Ho'ola Hamakua	Outpatient care	Acute care	Long term care	Total
Revenues		$0	$ 4,823,070	$ 4,823,070
Operating costs		0	5,493,517	5,493,517.0
Income(loss)		0	(670,447)	(670,447.0)
Operating costs				
Beds		2	48	
Occupancy rate		0%	96%	
Income(loss) per bed day		$0	$ (40)	

Kohala Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 450,911	$ 72,116	$ 1,676,863	$ 1,748,979
Operating costs	807,503	168,302	2,560,546	2,728,848
Income (Loss)	(356,592)	(96,186)	(883,683)	(979,869)
Beds		4	22	
Occupancy rate		5%	107%	
Income(loss) per bed day		$ (1,355)	$ (103)	

Ka`u Hospital	Outpatient care	Acute care	Long term care	Total
Revenues	$ 496,409	$ 40,174	$ 1,257,311	$ 1,297,485
Operating costs	749,081	131,357	2,002,429	2,133,786
Income (Loss)	(252,672)	(91,183)	(745,118)	(836,301)
Beds		5	16	
Occupancy rate		11%	100%	
Income(loss) per bed day		$ (472)	$ (127)	

Leahi Hospital	Outpatient care	Acute care	Long term care	Total
Revenues		$0	$ 14,939,497	$ 14,939,497
Operating costs		0	17,124,979	17,124,979
Income (Loss)		0	(2,185,482)	(2,185,482)
Beds		6	177	
Occupancy rate		0%	98%	
Income(loss) per bed day			$ (34)	

Maluhia Hospital	Outpatient care	Acute care	Long term care	Total
Revenues			$ 9,730,753	$ 9,730,753
Operating costs			11,576,076	11,576,076
Income (Loss)			(1,845,323)	(1,845,323)
Beds		None	158	
Occupancy rate			97%	
Income(loss) per bed day			$ (33)	

Source: Hawaii Health Systems Corporation, FY2001-02 accounting records

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Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Hawaii Health Systems Corporation on January 7, 2004. A copy of the transmittal letter to the corporation is included as Attachment 1. The responses from the chair and vice chair of the corporation's board, the chair of the board's finance and audit committee, and the corporation's chief executive officer are included as Attachments 2, 3, and 4, respectively.

The corporation and board members generally expressed their disagreement with a number of our findings and recommendations. Specifically, their responses take issue with our findings on the corporation's procurement practices and hiring of independent contractors, and our comparison of executive perks with those available to other managers in state government. The corporation claims that exemptions from statutory requirements, such as the State's procurement code, justify its practices, which it says are based on industry conventions, and that it does encourage competitive procurement. However, as our report explains in detail, the corporation's enabling statute mandates, for example, the development of procurement policies and procedures consistent with the goals of public accountability and public procurement practices. Our review of the corporation's contract files leads us to conclude that its procurement practices simply do not meet that standard. With regard to the independent contractor and management perk issues, our findings of inconsistencies between the corporation's actions and those commonly used in government or prescribed by law are well supported by specific examples cited in the report.

The responses also disagree with our finding that municipal leases used to finance infrastructure improvements and service expansions escape legislative scrutiny and may obligate the State. While acknowledging that it would welcome the conversion of current municipal lease debt to general obligation bonds by the Legislature, the corporation sees delays in receiving legislative approval for general obligation bonds as a key problem preventing their use. The corporation's municipal lease transactions avoid legislative scrutiny because they are not subject to the normal budgetary approval process and the corporation's disclosures of pertinent lease transactions occur after the fact. The scrutiny of the corporation's leasing projects prior to a commitment is necessary, because, if the corporation were to default on lease payments, it might depend on the Legislature to appropriate funding to avoid potentially life-threatening consequences. We recommended a long-term capital

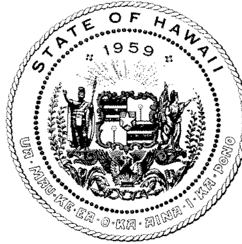
spending plan to facilitate such a review process and provide a vehicle to increase the number of projects financed through general obligation bonds instead of municipal leases.

Additionally, the responses question our findings related to the quality of financial analyses and projections used for decision-making and the lack of justification for hiring an independent contractor. However, our conclusions, based primarily on the data from the corporation's own records, are well supported by the facts.

We made minor changes to the draft report for clarity.

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

January 7, 2004

COPY

Mr. Thomas M. Driskell
President and Chief Operating Officer
Hawaii Health Systems Corporation
3675 Kilauea Avenue
Honolulu, Hawaii 96816

Dear Mr. Driskell:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Audit of Selected Procurement, Human Resource, and Fiscal Issues of the Hawaii Health Systems Corporation.* We ask that you telephone us by Friday, January 9, 2004, 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 Wednesday, January 14, 2004.

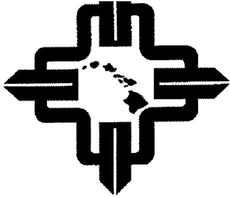
The Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

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

Enclosures



HAWAII HEALTH SYSTEMS
C O R P O R A T I O N

"Touching Lives Everyday"

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Maui

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Executive MAC

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Andrew Don, M.D.
At-Large

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Department of Health
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Lanai/Hana/Kauai

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Nii and Nii
Kauai

Kenneth H. Sandefur
Oahu

Russell T. Stodd, M.D.
At-Large

Clifton K. Tsuji
East Hawaii

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William Wood, Ph.D., Oahu

Jerry Broughton, East Hawaii

Reggie Morimoto, West Hawaii

Herbert H. Sakakihara, Maui

PHYSICIANS ADVY. GRP. CHAIR:

Anthony A. Manoukian, M.D.
Maui Memorial Medical Center

January 14, 2004

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to respond to the recent draft audit report of the Hawaii Health Systems Corporation (HHSC). In coordination with the Board of Directors, I am providing a response on behalf of the Board and management.

There have been tremendous successes achieved by HHSC both in operational monetary savings and validated quality healthcare to the communities throughout the State of Hawaii. You seem to have particular concerns with two areas of business practice concerning procurement and municipal lease financing. Based on concerns expressed throughout the report, you seem to have arrived at conclusions based on assumptions as follows:

First, the report assumes that HHSC should not be exempt from the State's procurement code; therefore, it concludes that "Procurement practices that may be common in the private sector conflict with the Legislature's stated commitment to open, competitive procurement," thus "the corporation's poor procurement practices increase its dependence on taxpayers." We beg to differ with the conclusion that "HHSC's poor procurement practices increase its dependence on taxpayers." The report acknowledges that HHSC is exempt from Chapter 103D, HRS. The report further assumes that HHSC should not be exempt from Chapter 103F, HRS. Additionally, the report further acknowledges "that the overriding goal in creating a corporation was to provide better health care for Hawaii's people including those served by small rural facilities, by freeing the facilities from unwarranted bureaucratic oversight." This guidance clearly supports HHSC's having flexibility to follow private practice models in some areas, such as procurement. HHSC completely embraces practices that are consistent with public accountability and competition. The fact is, HHSC has created a new procurement category called discretionary purchase to emulate rapid procurement implementation similar to private industry. Even when this category is evoked or when a contract is extended, there are still competition considerations, overall review by the Board, and accountability in all decisions. This process has resulted in saving millions of dollars through enhanced procurement practices.

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Second, the report assumes that HHSC should be coming to the Legislature for General Obligation (GO) Bond financing for major facility improvements and equipment purchases; therefore, the report concludes that "the corporation's use of lease financing circumvents legislative scrutiny and risks obligating the State." Again, we beg to differ with the conclusion regarding "the corporation's use of lease financing circumvents legislative scrutiny and risks obligating the State." If HHSC attempted to seek Legislative approval for every facility upgrade and equipment purchase, certain resultant delays would result in loss of services to the communities in need. Often, in spite of prior planning, multiple years lapse in the Legislature before GO Bond funding is approved for HHSC if approved at all. This was one of the key problems with the organizational structure that preceded HHSC, they could not get timely resource support in order to both implement emerging technology needs and to simply maintain the hospital facilities to accreditation standards as mandated by law. Thus, key hospital revenue services were given away to investors who could deliver the sorely needed equipment in a timely fashion. Subsequently, facilities were allowed to deteriorate beyond reason. HHSC has done much to rectify this deplorable situation. In the event that the Legislature desires to convert any current HHSC municipal leases to GO Bonds, that action would be welcomed. As far as circumventing the Legislature, full disclosure of all lease transactions is routinely reported in Board of Directors' public meeting minutes and each year, in January, a complete HHSC financial audit with full lease disclosure is provided to the President of the Senate and the Speaker of the House as well as the Governor.

Another significant concern with the draft audit report is that the decision was made not to hire an independent healthcare consultant. In the previous HHSC legislative audit just finished in April 2002, all parties involved found that the healthcare consultant hired to participate in that engagement brought balance to the audit by filling in for missing expertise.

Further, HHSC indigent care and uninsured care losses have increased from approximately $12 million in FY02 to almost $17 million in FY03. And, HHSC is facing a Long Term Care (LTC) crisis on Maui and Hilo where a total of approximately 90 patients remain in acute care hospital beds with little or no reimbursement because there is no where else for them to go. Not only are these patients receiving the wrong level of care, but HHSC is losing untold millions of dollars each year because there is insufficient LTC infrastructure to accommodate these patients.

Finally, the primary reason why HHSC must seek Legislative financial support each year is that HHSC is significantly under-reimbursed by government programs for services offered as a "Safety Net Hospital System." In this regard, we need to point out that HHSC was under-reimbursed by Medicare/Medicaid/Quest by approximately $45 million in FY02 (most current year information is available) up from approximately $35 million in FY01 and HHSC is now the ONLY public hospital system in the USA not eligible for Medicaid Disproportionate Share Hospital (DSH). DSH is critical to public hospital systems in Hawaii and throughout the USA. Although HHSC would annually qualify for millions of dollars in DSH payments as a "Safety Net Hospital System," it is precluded from eligibility because of Quest formulation decisions made by the State in the early/mid 1990's.

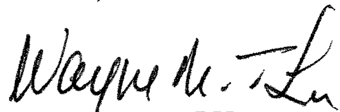
Also, HHSC has had to pay approximately $20 million additional contribution in FY04 and FY05 to the Employees Retirement System (ERS) compared to FY02. This ERS mandated contribution is a non-controlled expense imposed upon the Corporation by the State.

In spite of the challenges listed above, HHSC has been able to increase cash collections from $203 million in FY99 to $277 million in FY03. It is a combination of HHSC's aggressive cash collections, procurement flexibility, municipal leasing, and accountability that has enabled HHSC to be a nationally recognized, top performing public hospital system. By comparison, HHSC is only asking the State Legislature for support of approximately 10 percent of the $335 million annual HHSC program compared to the national average for all public hospitals in the USA of 20 percent support. HHSC is also considered among the top performing hospital systems in Hawaii both in terms of quality and finances. Quality performance has been validated by all annual HHSC hospital licensure surveys and by the fall 2002 Joint Commission on Accreditation of Healthcare Organizations (JCAHO) survey. HHSC participated as the first JCAHO system surveyed in Hawaii, the first JCAHO Critical Access Hospital surveyed in Hawaii, and received some of the highest survey scores in the USA. We must note that during the period FY98 though FY02, HHSC has been a consistent performer with operating losses only fluctuating between $18.5 million in FY98 to $29.9 million in FY02. HHSC has consistently controlled operating losses compared to other hospital systems in Hawaii. If HHSC's governance and management had not so expertly used its procurement practices and municipal leased financing during this measured five year period, the healthcare industry in Hawaii would have sunk further into a state of under-reimbursement. The burden for providing financial support to HHSC could easily now be two or even three times the current HHSC requested level of support.

Although the Legislative Auditor may not agree or accept some of HHSC's business practices because they may appear to sometimes come closer to emulating the private industry vs. other government agencies, the overarching end result of HHSC's success is fact. HHSC has dramatically reduced losses and costs to taxpayer compared to other hospital systems both nationally and in Hawaii, public or private. At the same time, HHSC has ensured the provision of quality, accessible and affordable healthcare services to all communities served by HHSC facilities. Further detailed facts to support these points are included in the two attachments to this letter.

Again, thank you for the opportunity to respond to this draft audit report of HHSC. We hope that you will take into account the points raised in this response. We would welcome the opportunity for dialogue which we hope can offer balance and equity to this audit.

Mahalo,



WAYNE M. T. LU
Chairman, Board of Directors
Hawaii Health Systems Corporation

Mahalo,

WILLIAM F. MIELCKE
Vice-Chairman, Board of Directors
Hawaii Health Systems Corporation

Enclosures:
1. Chair Fin/IS/Audit Committee Comments on Board Recommendations
2. CEO Comments on Management Recommendations

HAWAII HEALTH SYSTEMS CORPORATION

"Touching Lives Everyday"

January 14, 2004

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Anthony A. Manoukian, M.D.
Maui Memorial Medical Center

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion Higa
State Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813

Dear Ms. Higa:

Thank you for the opportunity to respond to the draft audit report of the Hawaii Health Systems Corporation (HHSC). At the direction of the full Board of HHSC, serving at the time that the audit was conducted, I am providing comments on recommendations in the draft report to the Corporation's Board of Directors.

I want to preface my remarks with the observation that the draft report appears to be characterized by conclusions drawn from either misinformation, misinterpretation and/or does not provide a complete, objective understanding of all the facts provided by HHSC during the audit. We ask that these concerns be addressed prior to issuing any audit report. Detailed comments on individual points in response to the recommendations in the draft report are as follows:

Recommendations to the HHSC Board of Directors, page 31:

1.a. The Board of Directors of the Hawaii Health Systems Corporation should:

Ensure, through improved procurement policies and strengthened oversight that the corporation's procurement practices are consistent with the goals of government accountability and procurement practices;

Response: The HHSC Board of Directors has provided appropriate oversight of the Corporation's procurement practices that are consistent with government accountability and procurement practices, as well as with the accountability and procurement standards of the healthcare industry. The Board of Directors has reviewed and strengthened or enhanced policies and procedures over time, as opportunities have occurred to improve practices. The information in the draft audit report on HHSC procurement practices contains misstatements of fact and conjectures that indicate a misunderstanding of competitive procurement practices in the business of healthcare and in the nature of joint ventures. I ask that you consider using the following information to edit the assumptions and findings of the draft audit report.

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Ms. Marion Higa
January 14, 2003
Page 2

Overall, as has been demonstrated in exhaustive detail over the last several years insufficient payments for services from government payers Medicare and Medicaid impose financial losses on our safety net hospitals of such overwhelming magnitude that, despite the dramatic increases in revenues and tremendous successes in reducing and controlling expenses, HHSC experiences substantial operating losses. This situation is exacerbated by the heavy costs imposed on the system of the employee retirement system (ERS) and the health insurance costs for employees and for retirees, as well as the State's collective bargaining agreements. The Corporation's good, aggressive procurement practices have saved the taxpayers many millions of dollars, but not enough to account for the heavy costs of under-reimbursement by government payers and high labor costs of the government workforce.

The draft report seems to characterize that it is somehow wrong for HHSC's policies and practices to differ in any way from the State procurement code. We believe that characterization is inaccurate. Act 262 empowered HHSC to create its own procurement policies and procedures, but with the recommendation that would be based on 103D. HHSC's policies and procedures and are, in fact, based in large part on 103D. The wisdom of the act creating HHSC gave the Corporation the power to vary from the more cumbersome process of chapter 103D when it is more expeditious and provides for more value. Also, in accordance with sound business principles, HHSC exercises discretion to award contracts with less than the full, cumbersome processes of 103D and to extend contracts when it is appropriate to do so, rather than force needless additional process and expense on the organization. HHSC is able to process "discretionary" contracts in less formal ways that provide as much or more effective competition and greater savings than the formal request for proposals process of chapter 103D. The draft report has stated an opinion that HHSC may not be exempt from Chapter 103F of the Hawaii Revised States. Chapter 103F clearly does not apply to HHSC, as Chapter 103F was created after HHSC was formed, it applies in large part to the work of the Department of Human Services, and HHSC is not one of the agencies identified in Chapter 103F as being covered by the chapter. This point can be quickly validated by referring it to the Office of the Attorney General for opinion on the non-applicability of Chapter 103F to HHSC.

Remarks on page 16 of the draft audit seem to indicate that there is not a full understanding of joint ventures. The joint venture with Clinical Laboratories of Hawaii, LLP was carefully and appropriately constructed to comply with all laws and to provide value to HHSC and the State of Hawaii, while maintaining HHSC's ability to negotiate best possible contract terms with the joint venture. A requirement of the joint venture is that each organization must be represented on The Governance Committee. Each minority member of this joint venture, Hawaii Pacific Health (HPH), St. Francis Healthcare Systems, and HHSC, has appointed a representative to serve on the Governance Committee of Clinical Laboratories of Hawaii, LLP. To infer that participation in the joint venture implies self-dealing is an unworthy misstatement that suggests personal benefit, something that we believe that your staff knows is not true. We believe that this portion of the draft audit report should be corrected. It is our opinion that HHSC's partnership with other Hawaii healthcare corporations in the Clinical Laboratories of Hawaii, LLC joint venture is one of the most successful public-private partnerships that the State of Hawaii has achieved; and that this accomplishment should be noted. Our effective management of procurement processes has been an important part of the tremendous success that HHSC has achieved in reducing expenses and increasing revenues over the years, as listed below:

1. Overall savings to Hawaii of $150 million in the past five-years compared to FY 97
2. NORESCO (Energy co-generation) savings of $23 million beginning in FY 99
3. Laboratory contract re-negotiation with ClinLab - $5 million savings per year since FY 97

4. Insurance re-negotiation - $1 million per year from FY 97 – FY 02

5. Medical Supply consolidation savings of $4 million per year since FY 97

6. Re-negotiation of third-party payer contracts - ($$ savings amount is proprietary information) since FY 97.

7. 340B pharmaceutical program (federal discount program for safety-net patients) - $200,000 per year

8. Consolidate equipment maintenance support, savings of $500,000 per year since FY 01

9. Reestablish hospital radiology services at four HHSC facilities = $2 million dollars in new revenue per year since FY02

We believe that Summary of Findings on page 11 of the draft report also do not recognize HHSC's improvements in reducing expenses and bringing value to the communities we serve, such as those listed immediately below:

1. Workers Compensation claims per 100 employees consistently reduced from 21.5 in FY 97 to less than 8 per year since then.
2. Achieved Critical Access Hospital (CAH) status for four HHSC hospitals and thereby enhanced HHSC revenue by $2.2 million per year starting in FY 02.
3. Increased HHSC revenues through enhanced cash collections from $247 million in FY 02 to $277 million in FY 03. In the last four years, HHSC increased cash collections $74 million from $203 million in FY 99 to $277 million in FY 03. The goal for FY 04 has been set at $298 million.
4. Foundation – from only 3 foundations in FY 07 to 10 foundations in FY 03 supporting HHSC facilities.
5. Established Rural Development Fund Nurse Training and Development Program HHSC-wide with $1million grant in FY 03.
6. Implemented restructuring plan under Voluntary Separation Incentive Program (VSIP) in FY 03 and FY 04.

HHSC management is providing additional information on procurement practices that I am confident will also help your staff to make corrections to the draft audit report.

1.b. The Board of Directors of the Hawaii Health Systems Corporation should:

> **Develop and implement policies for hiring independent contractors that ensure compliance with applicable state and federal laws;**

Response: The audit has brought attention to the use of independent contractors in the regions for a variety of special temporary needs. However, we do not agree that hiring of all our independent contractors lack justification and/or are misclassified. The overwhelming majority of our independent contractors are certainly justified as these contractors provided unique services or the terms of their services were temporary in nature. Well before the audit report was drafted, HHSC began working on an independent contractor policy to provide closer scrutiny and oversight from the Corporate level to assure appropriate review and use of non-personal services contracts. The policy was presented to the HHSC Board's

Personnel & Compensation Committee and Finance & Information Systems & Audit Committee on January 7, 2004. The policy will be presented to the full board for adoption on January 22, 2004.

1.c. The Board of Directors of the Hawaii Health Systems Corporation should:

> **Reassess its termination and separation policies for consistency with government practices in light of the corporation's dependence on legislative support.**

Response: The HHSC Board of Directors has judiciously implemented termination and severance standards for executives of the corporation. The issues of termination and severance must be considered in view of compensation and the ability to attract and retain capable executives and healthcare workers. Although HHSC is a State entity, the hospitals compete for employees, patients, and services with other healthcare providers and private sector industries both in Hawaii and nation-wide. This situation applies to top-level management positions as well as most healthcare personnel. Our industry is highly competitive and shortages for qualified professionals have grown tremendously over the years. For the civil service and certain exempt classes, HHSC instituted recruitment and retention incentives such as shortage differentials, hiring above the minimum, travel and moving reimbursements and retention bonuses. Classes affected included Registered Professional Nurses, Licensed Practical Nurses, Pharmacists, Radiologists, Social Workers, Physical Therapists, and many other related healthcare classes.

For top tier management personnel, experience at the hospital and in healthcare systems is crucial because of the myriad of complicated state and Federal laws, rules, regulations, and policies that are related to patient care, including the potential liabilities for not being in compliance with the same. As a result, HHSC (and other healthcare providers in Hawaii) have had to offer similar recruitment and retention benefits in an effort to find and keep a qualified management team. The HHSC Board of Directors took an arms-length approach to developing a compensation program for the organization and engaged the services of an independent consultant, William M. Mercer, to evaluate and provide recommendations that shaped the compensation structure. Mercer proposed programs that were competitive and reflected the market (lower-end) in which HHSC competes for managers and other exempt staff. As the audit noted, the Board eliminated the Mercer recommended incentive program based on performance goals in 2003 (with no offset in lost earning opportunity for program participants) after suspending the program in 2001 with the only incentives.paid since July 1998 going to employees who have left the corporation.

Based on the Mercer study, the Board adopted a severance plan that was to be used by eligible employees in the unlikely event of a change in control or sale of the organization. These employees under any other normal situation would not be eligible to receive severance and is exercisable only in such rare circumstances, thus it does not have an impact on the financial situation currently faced by HHSC. For example, a management employee who resigns, retires, or is terminated for cause is not entitled to receive any severance benefit. The severance plan currently in place is also a common tool used in many industries and professions; and the payment amounts are based on market conditions. The HHSC severance plan is modest by comparable industry standards.

The audit also stated that settlement agreements are another benefit provided to exempt employees that are not available to exempt employees at other State government agencies. It is an inaccurate statement in the draft audit report that settlement agreements are a unique benefit for HHSC and that other State government agencies do not enter into such settlement agreements. Settlement agreements are legal documents that are used by other agencies of the State of Hawaii to settle controversies involving collective bargaining agreements, civil rights agency proceedings, civil suits or contested terminations. These agreements are also commonly used by private businesses to settle controversies for any level of

employee. The terms and/or amounts contained in such agreements are negotiable between the employee, union representative, employer, and/or their respective legal counsel/attorneys and are used to avoid the expense of potential arbitration or litigation actions.

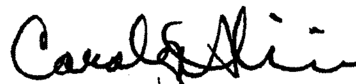
1.d. The Board of Directors of the Hawaii Health Systems Corporation should:

> **Establish and enforce accountability standards for both competence and reasonable accuracy in analyses and projections presented in support of investments in infrastructure and service additions.**

Response: This recommendation appears to be based on misstatements or lack of complete information in the draft audit report. Perhaps the two primary examples cited in the audit report were the investment in in-patient dialysis at Maui Memorial Medical Center and the investment in nuclear medicine at Kona Community Hospital. The facts and conclusions in the draft audit report concerning these two capital investments were incorrect, as management is documenting in a separate memorandum. We believe that the large number of misstatements and inappropriate conclusions in the draft audit report can be attributed to the failure to contract for external healthcare consulting expertise to this audit team. While it would have cost the State of Hawaii to contract with a public accounting firm or other consultant with the competency to audit and analyze the numerous areas that the audit team reviewed, the result of proceeding without consulting assistance was that audit team members were sent on audit misadventures, to no fault of their own, because of their lack of experience and training. In the legislative audit that finished in 2002, the healthcare consultant brought balance to the audit by filling in for missing expertise. Even though we were denied access to the 2002 healthcare consultant's work other than what was included in the final audit report, still we saw much balance in having this level of experience and expertise. The absence of this level of healthcare expertise during the current audit undoubtedly raises questions about the validity of some assumptions and conclusions in the report as well as the absence of other key positive information that has been noted in this response.

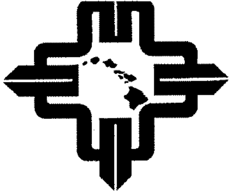
We hope that the additional facts and information above provide you with a well-rounded overall perspective that seeks to address the major concerns and misrepresentations identified in the draft audit report, thus enabling corrections to be made in the draft report in order to achieve a more balanced reporting picture We appreciate the opportunity to provide these clarifications.

Most sincerely,



CAROLYN AJNII, CPA
Chair, Board Finance, IS, and Audit Committee
Hawaii Health Systems Corporation

ATTACHMENT 4



HAWAII HEALTH SYSTEMS
CORPORATION

"Touching Lives Everyday"

January 14, 2004

COO/CFO-04-015

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion Higa
State Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to respond to the draft audit report of the Hawaii Health Systems Corporation. At the direction of the Hawaii Health Systems Corporation (HHSC) Board of Directors, I am providing comments on the recommendations and findings concerning management and the Legislature. HHSC Board leadership is providing comments separately on recommendations and findings concerning the Board of Directors.

In our opinion the findings in the draft report are mistaken, and conclusions presented are not substantiated by the information cited. The information presented in some cases is inaccurate. Detailed comments on each of the recommendations in the draft report follow:

Recommendations to the Corporation's management, page 31 and 32:

2.a. The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

Implement and enforce procurement procedures consistent with open competitive procurement:

HHSC has provided for substantial competition in its procurement practices and hails competition as a stalwart tenet of all processes. By establishing and following our own policies and procedures, based on, but different from Chapter 103D, we have been able to streamline our processes and save our hospitals and the State of Hawaii millions of dollars. I must point out that there is a large omission in your report concerning procurement competition that should be corrected – the outstanding competitive pricing value of our group purchasing organization (GPO), and our most excellent use of our GPO. As the Legislature in its wisdom specifically envisioned when it created HHSC, the corporation has entered into an extremely successful relationship with a group purchasing organization, MedAssets HSCA. By purchasing most of our supplies and pharmaceuticals through vendors on contract with MedAssets HSCA, we have reduced our expenses by many millions of dollars. While your staff may perceive that some of these purchases are lacking competition, the reality is that these purchases are based on quite effective competition. MedAssets HSCA acts for us by applying its very rigorous competitive process to provide value in pricing to HHSC. We find that our relationship with our GPO (MedAssets HSCA) is superior to the relationships that other hospitals have with GPOs, because we are not constrained by contract to use only MedAssets vendors and we are able to further negotiate with MedAssets vendors for enhanced savings and improved contract terms for things such as delivery costs. These negotiated arrangements may seem to those who are unfamiliar with industry practices to be unjustified discretionary

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procurements, when, in fact they are aggressive and creative actions by HHSC management and staff to further reduce costs that have already been competitively contracted. We are delighted that we have been able to achieve outstanding levels of compliance throughout the corporation and its facilities with purchasing through GPO vendors. Although HHSC is a government agency, because of the empowerment in Chapter 323F and HHSC's aggressive procurement practices, we have been able to achieve greater use of GPO vendors than other hospitals in the MedAssets HSCA system, so much so that in 2000 and 2002 we achieved compliance awards from MedAssets HSCA for highest compliance (highest percentage of total purchases) with GPO vendors. This means that more procurement by HHSC is with competition than the procurement of other hospitals, both private sector and public sector. The conjecture that HHSC procurement lacks competition is inaccurate, because, as these facts demonstrate, both competition and accountability are the key components of HHSC procurement practices.

Comments in the draft report seem to indicate that it is improper for HHSC policies and procedures or practices to vary from the procurement rules of Chapters 103D and 103F of the HRS, even though HHSC was authorized to do so by Chapter 323F, HRS, which exempted HHSC from Chapter 103D and by Chapter 103F (passed after HHSC was created) which did not include HHSC. Also, the fact that HHSC has been highly successful at controlling and reducing costs of goods, services and equipment does not seem to be taken into account. It is important to comment on the impact of the state procurement code on hospital purchasing prior to the creation of HHSC and the granting of authority to establish separate procurement policies and procedures. The state procurement code was so cumbersome and bureaucratic for the Division of Community Hospitals that the Division could not manage contracts and could not protect the hospitals from the predatory practices of vendors. The hospitals of the Division of Community Hospitals paid many millions of dollars more for supplies and equipment than other hospitals because of the constraining nature of the procurement code. Apparent competition provided by the code provided resulted in windfall profits for vendors but did not protect the hospitals.

2.b. The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

> **Ensure that hiring, including contracts for personal services, comply with prudent business practices and applicable laws and regulations;**

Response: The Corporation works hard to obtain specialized services at best possible pricing, sometimes on short notice for limited periods, in order to insure the provision of the highest quality healthcare to our patients and communities. We have already prepared and implemented an amendment to the HHSC procurement policy that will provide greater corporate oversight and evaluation of these special services.

We ask that you consider correcting some of the inaccuracies in the draft report, in order to more appropriately report the practices of the corporation in this functional area. Examples of inaccuracies in the draft report are in the discussion on dialysis services at Maui Memorial Medical Center. On page 17 it is stated that "The Maui Memorial Medical Center contract with the dialysis nurse was the result of a self-imposed emergency situation due to poor planning." This is a very inaccurate statement. In our opinion, the facts indicate that Maui Memorial Medical Center was able to complete the certificate of need process within two months in order to respond to the healthcare crisis. To say that the emergency situation was self-imposed or non-existent fails to value the lives of dialysis patients on Maui that were at risk because of the inability of the dialysis provider to provide services. Maui Memorial Medical Center planning was excellent in this case. The problem arose when the provider of dialysis services on Maui became unable to provide adequate services. The draft report refers to the high cost of the specialized nursing expert necessary to establish and operationalize the in-patient dialysis program, but does not explain why the contract was necessary. Although we were chagrinned at the cost, it was necessary to contract with a qualified individual from the mainland because the arrangement mediated by the State Health Planning and Development Agency (SHPDA) forbade HHSC from hiring any dialysis nurses who worked for current dialysis vendors in Hawaii. This mediation, which actually was a condition imposed on HHSC in

order to be allowed to implement a very necessary service, meant that HHSC was not able to locally hire an experienced dialysis nurse to set up the in-patient dialysis program. We ask that this important fact be included in the audit report. The establishment of in-patient dialysis was an action taken to provide healthcare services in a crisis, not an action taken to improve revenue. The "mediation" in the certificate of need process imposed needlessly higher costs on Maui Memorial Medical Center to provide this vital service. Despite the fact that MMMC established in-patient dialysis services to assure access to quality healthcare service, not for financial benefit, the cost to Maui Memorial Medical Center of running its own in-patient dialysis center has been less than it previously cost to contract for the service. Additionally, the contract option was no longer available as an option. The allegation on page 18 that this may have been a violation of the State's Fair Treatment Standards seems to be without merit.

2.c. The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

Develop and maintain a long-term capital spending plan.

We believe that HHSC has been effective at capital spending planning. For hospitals and hospital corporations such as HHSC, the foundational process for capital planning and for capital spending planning is facility master planning. Key elements for facility master planning are: **(1)** Joint Commission on the Accreditation of Healthcare Organizations (JCAHO) Statement of Condition (SOC); **(2)** List of medical buildings; **(3)** Schedule of planned facility projects, to include Energy Savings Performance Contract (ESPC) Projects. HHSC has a well-documented record of planning in these three areas as explained below:

Statements of Condition. Adequate statements of condition did not exist for HHSC facilities when the Corporation was created. Management took action to correct this serious shortfall. Two major corporate-level actions were taken to facilitate the development of adequate SOC's for the facilities. First, a system ad hoc committee titled the Engineering Task Force (ETF) was created to advise management at all levels and to work on system-wide facilities and engineering issues. Secondly, through fully-competitive Request for Proposal (RFP) process an engineering firm, Tower Enterprises, was engaged to provide engineering advice and assistance to the ETF and to management at the Corporate level and to leaders at facility level. Tower Enterprises has worked with facilities to provide detailed SOCs for very successful surveys by JCAHO in 1999 and again in 2002. These planning documents have also been instrumental in providing effective information to the Hawaii Legislature for CIP submissions and to enable management and the HHSC Board of Directors to develop and establish capital equipment and renovations budgets, with some projects qualifying for internal funding via municipal lease financing.

Listing of Medical Buildings. When HHSC was established there was no comprehensive inventory and assessment of buildings. Only scattered and inconsistent architectural drawings, either as-built or as-designed were available. This severely limited the ability of the Corporation to assess facilities or adequately plan for improvement of facilities. To correct this deficiency we have obtained all available drawings of HHSC facilities by auditing files at the Department of Administration and General Services (DAGS) and by using these drawings and conducting surveys of all buildings on all facilities, we have now documented virtually all square footage of HHSC facilities on detailed, accurate, up-to-date digitized Computer-Aided Drawings (CAD) files available for use at Corporate level and at each region. The output of this work can be seen in the 2002 SOC's for Kona Community Hospital (KCH), Hilo Medical Center (HMC), and Kauai Veterans Memorial Hospital (KVMH) and is instantly available for review via cataloged CD Rom technology vs. the prior process of trying to locate drawings from multiple locations and multiple piles of paper often several feet thick.

Energy Savings Performance Contract (ESPC) Projects. For each of our campuses, NORESCO, LLP has completed a Detailed Energy Analysis (DEA) fully documenting all energy savings actions being completed. Representative sections of the DEA's for KCH, HMC and KVMH have been provided to your staff for reference. The DEA is being developed at this time for Maui Memorial Medical Center (MMMC). Because of the authority provided to HHSC by the State of Hawaii and HHSC's ability to conduct effective facility planning, the energy services performance contracting for MMMC is being coordinated with the major construction at MMMC being funded by $38 million in general obligation bonds in order to leverage the use of State funds and in order to integrate the energy-consuming systems of the new construction with the campus energy management plan, to be documented in the DEA being developed in conjunction with NORESCO, LLC. Please note that the NORESCO, LLP energy conservation construction contract in effect with HHSC was awarded through a fully competitive RFP process with multiple vendors competing for this business.

HHSC management is proud of the excellent record of the corporation with capital planning and investments and the tremendous improvements that the Corporation has been able to achieve on its campuses system-wide. There is still much that remains to be done to enhance HHSC facilities and plan for the future needs of our communities.

2.d. The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

Ensure that analyses and projections submitted for capital investments are performed competently and are accurate and complete;

We cannot agree with the premise of this recommendation and offer additional information in explanation. Further research indicates that two instances of pro forma financial analyses for capital investments that the draft report describes as flawed were in actuality effective analyses that subsequent operating results validated. It is important to note that management provides the Board of Directors with a pro forma financial analysis for every new capital investment project over $500,000. In performing these analyses, management is conservative in making the financial assumptions so as not to enter into capital investments that will not eventually provide positive cash flow. For large undertakings, management has engaged external professionals to validate management's financial analysis. For example, for the Hilo State Veteran's Home project, the final financial feasibility study was performed by Health Dimensions Group, a specialist in evaluating the feasibility of state veteran's homes; and Health Dimensions was selected on a competitive basis

In the case of the Maui Memorial Medical Center (MMMC) in-patient dialysis program, financial projections were based upon assumptions as is the case in all cost benefit projections. One key assumption, as has already been alluded to earlier in this paper, was that one of two locally established dialysis providers would be allowed to contract with MMMC to provide this service if a Certificate of Need (CON) was authorized. Unfortunately, the mediation associated with the CON process resulted in a restricted CON agreement where neither of the two primary local dialysis providers was allowed to contract with MMMC to provide in-patient dialysis service. Also, a precise timeline was established for MMMC to operationally the service. Thus, the end result was a necessity for MMMC to resort to rapid and expensive mainland recruitment of the expertise necessary to implement the program within the established timeframes. Accordingly the initial projections had to be modified to take into account the parameters by the CON process decisions and cost vs. need decisions had to be made as MMMC balanced hospital financial concerns against the level of magnitude of the need for in-patient dialysis on the island of Maui. Although the service start-up was more expensive that initially hoped for, still, the first year cost were less than would have been expended under the previous contract support arrangement.

In the case of the Kona Community Hospital nuclear medicine investment cited by the auditor, the draft audit report omitted the information that management did not procure the nuclear medicine equipment until a second pro forma financial analysis was done that remedied all of the deficiencies noted in the audit report. This second pro forma can be found in the minutes of the meeting of the HHSC Board of Directors on July 11, 2002. In fact, for fiscal year 2003, the nuclear medicine department has performed better than what was projected in the second pro forma analysis. The revised pro forma showed a projected accrual loss of ($112,133) which was made up by a $135,000 donation from the Kona Community Hospital Foundation. The operating results of the nuclear medicine department for the first five months of operation in FY 03 were a net margin of $114,418. The projected margin after five months of FY 04 is approximately $250,000. These results validate that the Board made a good decision to improve level of service in Kona and obtain a net positive return.

2.e. The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:

To the extent possible, identify and submit for legislative approval major infrastructure projects for financing via general obligation bonds.

Every fiscal biennium, HHSC submits to the legislature an extensive list of requested CIP projects to be funded by State general obligation bonds. Some of the projects approved by the Legislature in the past have been critical to HHSC's success, most notably the life safety code improvements at four of our long-term care facilities with acute care licenses which allowed them to become critical-access hospitals and the $38 million major construction project at Maui Memorial Medical Center. HHSC is deeply appreciative of this CIP support from the Legislature and would welcome further legislative support for major infrastructure support for its facilities, including, but not limited to, information technology projects and facility renovations. However, management understands the current fiscal situation of the State of Hawaii, and management acknowledges that while the legislature would like to approve all of HHSC's infrastructure requests, resources are scarce and must be judiciously allocated among all State agencies.

It must be noted that the majority of the items that HHSC leases through its municipal leasing lines is for equipment with useful lives of between five and seven years. Those types of assets are extremely difficult to finance through general obligation bonds because purchasers of general obligation bonds do not want bonds where the underlying assets being financed have a useful life much less than standard bond terms. This is the reason why general obligation bonds are used to finance infrastructure and building improvement types of assets, since their useful lives will correspond to bond terms. Purchasers of such bonds feel secure that, in the unlikely circumstance that the State is not able to comply with the terms of the bond, they at least have a security interest in assets that have a net book value that is comparable to the remaining obligation on the bonds.

Therefore, management would ask the report reconsider the key point that by using municipal lease financing, HHSC is acquiring necessary medical equipment and information systems at the lowest cost to the State. The only alternative to municipal leasing would be to acquire these assets through operating leases, which would bear interest at substantially higher rates than municipal leases (typically 8-10 percent). This means that HHSC is saving the State of Hawaii on a conservative estimate 1.8 percent, when you compare HHSC's average municipal lease interest rate of 6.2 percent to the 8 percent interest rate on operating leases. Applying the savings of 1.8 percent against HHSC's audited capital lease obligation balance at June 30, 2003 of approximately $32 million, HHSC has saved the State of Hawaii approximately $575,000 each year through its use of municipal lease financing. Also, HHSC has established an innovative business practice that is recognized by the legislature as providing value, as indicated by the law passed in 2001 to authorize the Director of Finance to establish a municipal leasing program for the State.

Sixth Recommendation **The Corporation's management should strengthen contract and capital asset management practices. Specifically, it should:**

f. Establish, at a minimum, uniform standards for accounting for and safeguarding capital assets.

The draft report states that "expensive capital inventories are poorly safeguarded." If such conditions truly existed at HHSC's facilities, then HHSC's financial statement auditors, Deloitte & Touche LLP, would have noted that as a material weakness in its report on compliance and on internal control over financial reporting, which accompanies every annual audited financial statement. As part of their audit, Deloitte & Touche LLP does perform tests of internal controls over the fixed asset cycle, which includes the processes for accounting for and safeguarding fixed assets. However, since the fiscal year 1998 financial statement audit, there have been no material weaknesses reported for HHSC in any area.

Management acknowledges that there are several types of systems used by the facilities as a subsidiary ledger for their capital assets. However, for smaller facilities, a simple Excel spreadsheet is probably the most efficient way to keep track of such assets. While HHSC would certainly like to have a standard fixed asset inventory system for all of its facilities, management has weighed the cost-benefit of purchasing such a system against the needs to comply with federal mandates such as HIPAA and the need for medical equipment to continue the high quality of care provided to the State of Hawaii. Management has decided that purchasing a standard fixed asset system for all facilities is important, but given our tremendous demand for new clinical, billing and regulatory automation systems, it is not a high enough priority to warrant funding at this time.

The draft report includes two recommendations concerning the Legislature on which we offer comments.

Recommendations to the Legislature, page 32:

3.a. The Legislature should:

Clarify its intent regarding whether or not the Corporation should be exempt from Chapter 103F, HRS,

Response: We think that the Legislative intent was clear when HHSC was created with an exemption to Chapter 103D, HRS and when HHSC was excluded from Chapter 103F upon implementation. We agree with referring this issue to the Attorney General for formal ruling on this point as a means of truly addressing the assumption and associated conclusions in this report pertaining to HHSC procurement practices.

3.b. The Legislature should:

As part of its budget review process, require the Corporation to provide adequate information to evaluate plans to use municipal leases for financing infrastructure improvements and additions of new services.

Response: HHSC already provides substantial visibility over its municipal leasing activities and on infrastructure improvements and additions of new services to the Legislature and to the Director of Budget & Finance.

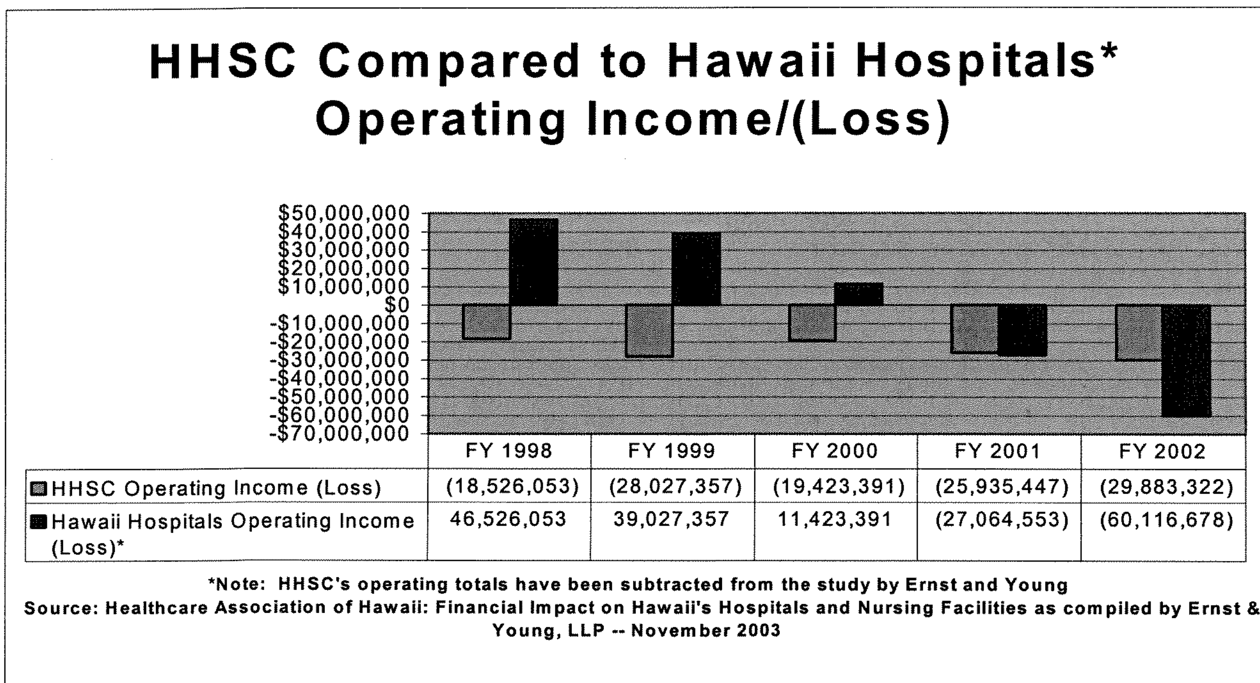
Management disagrees with the finding in the draft report that HHSC's use of municipal lease financing "circumvents Legislative scrutiny and may further obligate the State." We ask that you consider amending the language in the draft report on this issue, based on the following information and explanations. First, HHSC has never hidden the fact that it has entered into municipal leasing lines. To the contrary, Management in reports and briefings, testimonies, has repeatedly highlighted how it has creatively and appropriately utilized municipal leasing to invest in important initiatives to improve quality of care, improve quality of facilities, to increase revenues, and to reduce operating expenses. HHSC accounts for its municipal leases according to General Accounting Principles (GAP) accepted both in Hawaii and throughout the United States of America, which requires HHSC to record an asset and capital lease liability for such leases as HHSC receives the benefit of the asset's useful life. The current and non-current portions of the capital lease liability are clearly disclosed in HHSC's internally produced monthly financial statements. These financial statements are presented to the HHSC Board of Directors and the Board Finance, Information Systems, and Audit Committee at each regularly scheduled meeting. Also, a separate report with details on each municipal lease schedule and its related liability is presented periodically to the Board of Directors and the Board Finance, Information Systems, and Audit Committee. A representative of the Department of Budget and Finances often sits in on both the Board Finance, Information Systems, and Audit Committee meetings as well as Board of Directors meetings. Both the monthly financial statements and the separate municipal leasing report are included in the minutes to the meetings of the Board of Directors, which are a matter of public record and available to anyone who wishes to see them. Also, the audited financial statements of HHSC contain a separate footnote describing the municipal lease arrangement. This footnote disclosure has been part of every HHSC financial statement audit since fiscal year 1999, which was the year HHSC's municipal leasing program started. A copy of HHSC's annual financial audit report is submitted to the Legislature as part of HHSC's required annual report to the Legislature, and, as such, is a matter of public record. Further, HHSC has included the cash flow impact of its current and anticipated municipal leasing requirements in computing its biennium budget requests for general fund support. This information is provided to Legislative budget analysts when the budget request is submitted. HHSC staff spends a substantial amount of time each year explaining how the capital lease payments factor into the biennium budget requests.

Second, the possibility that the State would ever be held liable for failure to make lease payments is extremely remote. As part of the annual budgeting process, HHSC forecasts not only the cash it needs for its operating budget, but also the cash needed to finance its capital budget. Depending on the level of cash collections compared to budget and the level of expenditure control compared to budget, HHSC releases authority to enter into a municipal leasing schedule only when it appears that sufficient cash will be available to cover the additional monthly debt service payments. In this process retired municipal lease debt service is also taken into account. HHSC also provides the lenders with its annual audited financial statements as well as its annual operating budget. If the lenders ever felt that HHSC would not be able to meet its debt service requirements, the lenders would no longer continue allowing HHSC to enter into lease schedules. Should HHSC ever be in the situation where it could not generate sufficient cash flow to meet its capital lease obligations, the most likely scenario would be that the lenders would work with HHSC to develop a payment schedule that would work with HHSC's cash flow situation. Only in a worst-case scenario would the lenders actually seek to take back the assets underlying the lease schedule, which the lender would then put up for sale in order to recoup the remaining amounts owed under the lease. Therefore, it stands within reason that the likelihood of the State of Hawaii ever being liable for HHSC's capital lease obligations is very slim, indeed.

Without the municipal leasing program, HHSC would have a very difficult time finding other venues for acquiring capital equipment without having to pay exorbitant amounts for such assets. In order for HHSC to maintain its quality of care for the State of Hawaii, it must keep up with the advances in medical and information systems technology that enhance the quality of care for patients. The municipal leasing program gives HHSC the ability to keep up with such technological advances and also the flexibility to

acquire these types of assets as soon as management has negotiated an acceptable price without having to go through a lengthy Legislative approval process.

It is our opinion that the two findings on page 11, that we believe are incorrect, are contradicted by the performance record of the corporation. HHSC has been able to make substantial improvements in healthcare quality while increasing revenues and controlling costs. During the last several years the healthcare industry, including hospitals, has been in financial crisis throughout the United States and in the State of Hawaii. The financial situation of the hospitals in Hawaii has worsened dramatically over the past four to five years, as the Healthcare Association of Hawaii (HAH) has repeatedly testified to the Legislature during this period. Consecutive studies by Ernst & Young, LLP have documented this crisis situation for Hawaii's hospitals. The bar chart below shows how the financial situation of other hospitals in Hawaii (less HHSC) dramatically declined, from positive aggregate net income of approximately $46.5 million in 1998 to aggregate net losses of approximately $27 million in 2001 and even heavier losses of approximately $60 million in 2002. During this same period, HHSC financial performance has remained relatively stable, with losses varying from approximately $18.5 million to $29.9 million. This consistent financial performance can be attributed in large part to HHSC's aggressive, competitive procurement practices and use of municipal lease financing as well as the implementation of both individual and facility accountability throughout the system.



	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
HHSC Operating Income (Loss)	(18,526,053)	(28,027,357)	(19,423,391)	(25,935,447)	(29,883,322)
Hawaii Hospitals Operating Income (Loss)*	46,526,053	39,027,357	11,423,391	(27,064,553)	(60,116,678)

*Note: HHSC's operating totals have been subtracted from the study by Ernst and Young
Source: Healthcare Association of Hawaii: Financial Impact on Hawaii's Hospitals and Nursing Facilities as compiled by Ernst & Young, LLP -- November 2003

The report under discussion is the third audit of HHSC in the past five years. At the start of both the first and second audits as well as the start of this audit, we asked the audit team to please advise HHSC immediately if they identified any activity or practice that they think may result in inefficiency or need major improvement. HHSC personnel could then interact with the audit team to develop a full understanding of the concern, provide further information, if indicated, and take immediate action if warranted versus having to wait for an extended period of time to finally read about the concerns in the draft/final report. This suggested approach is clearly in line with collaborative process modifications that have been implemented by many Federal and governmental audit agencies throughout the USA. Although the suggested process was not agreed to for this recent HHSC audit nor the previous two HHSC audits, we request that the process change be considered for future legislative audits as a means of

enhancing the return on investments on time spent by all participants in the audit process as well as a means of facilitating more timely implementation of recommendations when indicted.

Finally, I must express concern that an independent healthcare consultant was not engaged to participate in the audit process with this audit team. In the previous HHSC audit completed in April 2002, the use of an independent healthcare consultant to supplement work done by the audit team brought to the process a much enlightenment and more definitive understanding of the complex, regulated and legally scrutinized healthcare environment in which HHSC operates. Please consider the supplemental use of appropriate consultant(s) in future healthcare related audits as a way not only to validate work done by the audit team, but also to insure a more complete understanding of all processes and practices being evaluated.

Again thank you for the opportunity to respond to the draft audit report. We hope that our comments and responses will help to clarify indicated key points and thus be reflected in the final audit report. We also request that this letter of response, along with the cover letter and letter concerning Board recommendations, be appended to the final report.

Most sincerely,

THOMAS M. DRISKILL, JR.
President and Chief Executive Officer
Hawaii Health Systems Corporation

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Hawaii Health Systems Corporation on January 7, 2004. A copy of the transmittal letter to the corporation is included as Attachment 1. The responses from the chair and vice chair of the corporation's board, the chair of the board's finance and audit committee, and the corporation's chief executive officer are included as Attachments 2, 3, and 4, respectively.

The corporation and board members generally expressed their disagreement with a number of our findings and recommendations. Specifically, their responses take issue with our findings on the corporation's procurement practices and hiring of independent contractors, and our comparison of executive perks with those available to other managers in state government. The corporation claims that exemptions from statutory requirements, such as the State's procurement code, justify its practices, which it says are based on industry conventions, and that it does encourage competitive procurement. However, as our report explains in detail, the corporation's enabling statute mandates, for example, the development of procurement policies and procedures consistent with the goals of public accountability and public procurement practices. Our review of the corporation's contract files leads us to conclude that its procurement practices simply do not meet that standard. With regard to the independent contractor and management perk issues, our findings of inconsistencies between the corporation's actions and those commonly used in government or prescribed by law are well supported by specific examples cited in the report.

The responses also disagree with our finding that municipal leases used to finance infrastructure improvements and service expansions escape legislative scrutiny and may obligate the State. While acknowledging that it would welcome the conversion of current municipal lease debt to general obligation bonds by the Legislature, the corporation sees delays in receiving legislative approval for general obligation bonds as a key problem preventing their use. The corporation's municipal lease transactions avoid legislative scrutiny because they are not subject to the normal budgetary approval process and the corporation's disclosures of pertinent lease transactions occur after the fact. The scrutiny of the corporation's leasing projects prior to a commitment is necessary, because, if the corporation were to default on lease payments, it might depend on the Legislature to appropriate funding to avoid potentially life-threatening consequences. We recommended a long-term capital

spending plan to facilitate such a review process and provide a vehicle to increase the number of projects financed through general obligation bonds instead of municipal leases.

Additionally, the responses question our findings related to the quality of financial analyses and projections used for decision-making and the lack of justification for hiring an independent contractor. However, our conclusions, based primarily on the data from the corporation's own records, are well supported by the facts.

We made minor changes to the draft report for clarity.