
Financial Review of the Hawaii Health Systems Corporation

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Report No. 08-08
April 2008



THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai'i 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.

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



THE AUDITOR STATE OF HAWAII

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OVERVIEW

Financial Review of the Hawaii Health Systems Corporation

Report No. 08-08, April 2008

Summary

The Office of the Auditor and the certified public accounting (CPA) firm of Accuity LLP conducted a financial review of the Hawaii Health Systems Corporation, a public body corporate and politic and an instrumentality and agency of the State of Hawai'i, for the fiscal year July 1, 2005 to June 30, 2006. The review included inquiry and analytical procedures, as well as examining the reports, records, and other relevant documents to assess the corporation's compliance with state procurement laws and to determine whether the corporation's financial statements are presented in conformity with applicable accounting principles. We also performed procedures focused on the corporation's procurement policies, compliance with the state procurement laws, lease financing arrangements, information systems, the patient billing cycle, safeguarding of capital assets, and management of conflicts of interest.

The firm was unable to render a review opinion on the corporation's financial statements as corporation management refused to sign a representation letter acknowledging its responsibility for the fair presentation of its own financial statements. Despite this being a standard review procedure, the corporation repeatedly refused to sign the representation letter unless it was first allowed to review information that is unrelated to the representations being made. The corporation also did not provide adequate responses to several analytical inquiries that were material to its financial statements, further preventing the firm from completing its review procedures. These problems resulted in significant delays in the completion of the engagement, and prevented the firm from opining on the corporation's financial statements and including those statements in this report.

With respect to the corporation's internal control over financial reporting and operations, we found three material weaknesses. First, we found that the corporation's procurement and asset management policies and practices do not comply with applicable state laws. The corporation's original exemption from the Hawai'i Public Procurement Code was repealed prior to FY2005-06, the period under review; however, the corporation did not revise its internal policies to comply with state laws. For example, the corporation continued to use \$100,000 as its threshold for small purchases, while state laws applicable at the time set this threshold at \$25,000. Further, the corporation claimed its procurement code exemption was reinstated by the Legislature subsequent to the period under review; however, a review of the related legislation supported no such claim and current laws specifically state that the corporation shall be subject to the procurement code. The corporation also unilaterally determined it has always been exempt from Chapter 103F, Hawai'i Revised Statutes (HRS), *Purchases of Health and Human Services*. However, the related documents provided by the corporation do not support such claims. As a result, we found several specific violations of the state laws governing procurement and asset management.



The second material weakness is that the corporation's inattention to information technology (IT) management exposes its sensitive information to unnecessary risk. The corporation has outsourced a majority of its core IT activities to third party vendors and has placed significant reliance on these vendors to ensure that the corporation's systems and applications are secure and operating properly without the corporation having an adequate system to monitor vendor activity. The third material weakness is that not all of the corporation's facilities have, or adhere to, established billings, collections, and receivables policies. An example of a negative result of this was the corporation's loss of approximately \$204,000 it was due from Medicare and Medicaid because the related claims at various corporation facilities had not been submitted within the required 365 day timeframe.

During our review, we also encountered several other reportable matters. First, as previously mentioned, a general lack of management cooperation resulted in the delayed completion of the engagement and inability for us to opine on the corporation's financial statements. Second, the corporation's June 30, 2006 financial statements excluded \$4 million in bond fund appropriations. Third, the corporation's compensation structure is not comparable to other state agencies. For example, compensation packages for the corporation's top executives include housing allowances, retention bonuses, severance packages (up to 200 percent of base salary plus housing allowance), and salaries that are two to three times that of other state department heads.

Recommendations and Response

We made several recommendations regarding the corporation's operations. Among these, we recommended that the corporation revise its current procurement policies and practices to comply with applicable state laws; commit adequate resource to its information technology practices; and establish and enforce consistent customer billing procedures. We also made a number of recommendations to Hawaii Health Systems Corporation's management and corporate board of directors.

In its response to our draft report, the Hawaii Health Systems Corporation was extremely critical of our overall engagement approach, and claimed our process and identified material weaknesses did not meet applicable attestation standards. The corporation also disputed nearly all of our individual findings.

Our contracted CPA firm, Accuity LLP, spent considerable time inspecting documents; conducting interviews; and reviewing the corporation's processes over procurement and asset management, customer billing, information technology, and conflicts of interest. We believe the report presents an accurate and balanced analysis of the corporation.

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A Report to the
Governor
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Hawai'i

Conducted by

The Auditor
State of Hawai'i
and
Accuity LLP

Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 08-08
April 2008

Foreword

This is a report of the financial review of the Hawaii Health Systems Corporation, a public body corporate and politic and an instrumentality and agency of the State of Hawai'i, for the fiscal year July 1, 2005 to June 30, 2006. The review was conducted pursuant to Section 23-4, Hawai'i Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The review was conducted by the Office of the Auditor and the certified public accounting firm of Accuity LLP.

We wish to express our appreciation for the cooperation and assistance extended by the staff of the Hawaii Health Systems Corporation.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

This is a report of our financial review of the Hawaii Health Systems Corporation, an administratively attached agency of the Department of Health, State of Hawai'i. The review was conducted by the Office of the Auditor and the independent certified public accounting firm of Accuity LLP. The review was conducted pursuant to Section 23-4, Hawai'i Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawai'i and its political subdivisions.

Background of the Hawaii Health Systems Corporation

The Hawaii Health Systems Corporation was created as an administratively attached agency to the Department of Health in 1996 by Act 262, Session Laws of Hawai'i (SLH) 1996. The act transferred all state public health facilities previously under the administration of the Department of Health's Division of Community Hospitals to the corporation. The corporation currently operates 12 public health facilities, located on five islands within the State of Hawai'i. The corporation has approximately 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 facilities.

Organization

Board of directors

The corporation is governed by a 13-member board of directors consisting of the former director of health, ten governor-appointed members, the chair of the public health facility management advisory committee, and a regional physician. All members of the board are knowledgeable of Hawai'i's unique cultural diversity and health needs, and they are representatives of the total community from medical statesmen to business leaders, physicians, and public-policy makers.

Executive management team

The corporation's board of directors relies on the executive management team for advice and counsel. The executive management team consists

of the corporation's president and chief executive officer, chief operating and financial officer, chief information officer, director of human resources, general counsel, director of public relations, and five regional chief executive officers.

Corporation office

The corporate office provides leadership and guidance to the 12 facilities, in an effort to centralize and standardize system-wide administrative policies and procedures.

Facilities

The corporation operates 12 public hospitals and health facilities on five islands (O'ahu, Hawai'i, Maui, Kaua'i, and Lāna'i). These 12 facilities are further divided into five regions, each managed by a regional chief executive officer under the overall management responsibility of the corporate chief executive officer, as follows:

- **O'ahu** – Maluhia and Leahi Hospital
- **East Hawai'i** – Hilo Medical Center, Hale Ho'ola Hamakua, and Ka'u Hospital
- **West Hawai'i** – Kohala Hospital and Kona Community Hospital
- **Maui** – Maui Memorial Medical Center, Kula Hospital, and Lāna'i Community Hospital
- **Kaua'i** – Kauai Veterans Memorial Hospital and Samuel Mahelona Memorial Hospital

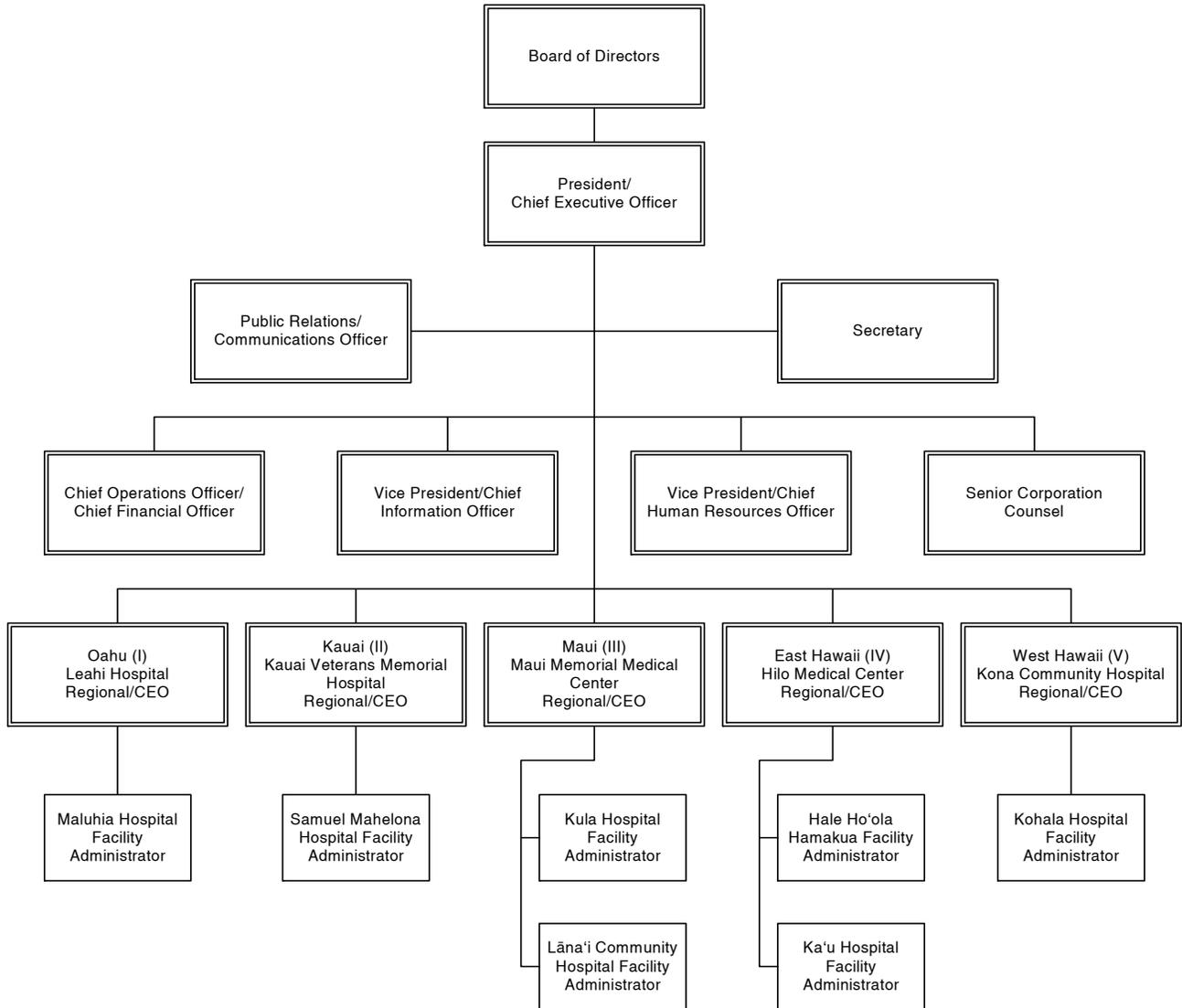
Prior Audits

There have been six audits and studies on the State's hospital system since 1988. Since the creation of the corporation in 1996, there have been three reports issued by the State Auditor.

In the *Audit of the Hawaii Health Systems Corporation*, Report No. 99-09, there were 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, it was recommended that the corporation's board of directors make it a priority to establish procurement policies consistent with the goals of public accountability and procurement practices.

**Exhibit 1.1
Organization of the Hawaii Health Systems Corporation**



Source: Hawaii Health Systems Corporation

Recommendations included improving controls over contract expenditures; increasing compliance with procurement and contracting policies; improving processes for selecting vendors and for establishing, administering, monitoring, and evaluating contracts; and creating audit trails for all purchases.

In the *Audit of Selected Procurement, Human Resources, and Fiscal Issues of the Hawaii Health Systems Corporation*, Report No. 04-03, the board of directors was recommended to ensure the corporation's procurement practices are consistent with the goals of government accountability and procurement practices and to implement policies for hiring independent contractors to comply with applicable state and federal laws. Management was also recommended to implement and enforce procurement procedures consistent with open and competitive procurement; ensure that hiring comply with prudent business practices and applicable laws and regulations; develop and maintain a long-term capital spending plan; and establish uniform standards to account for and safeguard capital assets.

Objectives

The objectives of the agreed-upon procedures are as follows:

1. Assess the extent to which Hawaii Health Systems Corporation has complied with the procurement code, including the awarding of discretionary and personal services contracts.
2. Assess the extent to which the corporation uses, accounts for, manages, and reports lease financing arrangements.
3. Assess the extent to which the corporation manages its various information systems.
4. Assess the extent to which the corporation accounts for, reports, and safeguards its customer billings, cash collections, and accounts receivable.
5. Assess the extent to which the corporation monitors and manages conflicts of interests.
6. Make recommendations as appropriate.

Scope and Methodology

The objective of the consolidated financial statement review is to express limited assurance that there are no material modifications that should be

made to the consolidated financial statements for them to be in conformity with generally accepted accounting principles (GAAP). This objective is accomplished primarily through the performance of inquiry and analytical procedures.

We attempted to review the corporation's consolidated financial statements and performed additional agreed-upon procedures of certain corporation transactions and internal control systems for the fiscal year July 1, 2005 to June 30, 2006. The agreed-upon procedures focused on the corporation's procurement policies, compliance with the state procurement laws, lease financing arrangements, information systems, the patient billing cycle, safeguarding of capital assets, and the corporation's management of conflicts of interests. Procedures performed included the examination of reports, records, and other relevant documents to assess the corporation's compliance with state procurement laws and to determine that there are no material modifications that should be made to the corporation's financial statements for them to be in conformity with GAAP. Site visits were conducted at 12 of the 13 facilities (the Yukio Okutsu Veterans Care Home was not fully operational in FY2006). We observed processes, conducted interviews, and reviewed documentation relating to procurement, capital assets, billings, and financial management. Our assessment of the corporation's information systems was limited to interviews and other correspondence with various management personnel in the corporation's information technology department.

The review was conducted from September 2006 through June 2007 in accordance with accounting and review standards generally accepted in the United States of America as set forth by the American Institute of Certified Public Accountants and the standards applicable to financial reviews contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Although fieldwork was substantially completed as of June 2007, we attempted to address a few significant but unresolved items with the corporation's management through December 2007. Unfortunately, the corporation's management did not adequately address these items, preventing us from opining on the corporation's June 30, 2006 financial statements and including those statements in this report.

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Chapter 2

Internal Control Deficiencies

Internal controls are steps instituted by management to ensure that objectives are met and resources safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Hawaii Health Systems Corporation.

Summary of Findings

We found several material weaknesses and other reportable matters involving the corporation's internal or management controls. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce, to a relatively low level, the risk that misstatements in amounts that would be material to the financial statements being audited or the risk that noncompliance with the applicable requirements of laws and regulations caused by error or fraud may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Reportable conditions, which are less severe than material weaknesses, are significant deficiencies in the design or operation of the internal control over financial reporting and compliance that, in our judgment, could adversely affect the corporation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements or comply with the applicable requirements of laws and regulations.

We consider the following matters to be material weaknesses:

1. The corporation's procurement and asset management policies and practices did not comply with applicable state laws during the period reviewed, and may not comply with such laws now.
2. The corporation's inattention to information technology management exposes its sensitive information to unnecessary risk.
3. Not all of the corporation's facilities have established policies regarding billings, collections, and receivables, and such policies when established, are not always adhered to.

We also noted the following additional reportable matters:

1. Lack of management cooperation resulted in the delayed completion of the engagement and inability to opine on the corporation's financial statements.
2. The corporation's financial statements excluded \$4 million in bond fund appropriations.
3. The corporation's compensation structure is not comparable to other state agencies.

The Corporation's Procurement and Asset Management Policies and Practices Did Not Comply With Applicable State Laws During the Period Reviewed, and May Not Comply With Such Laws Now

Act 262, Session Laws of Hawai'i 1996, established the corporation as "a body corporate and politic, and an instrumentality and agency of the State." In establishing the corporation, the Legislature acknowledged the need for appropriate administrative flexibility and autonomy to keep Hawai'i's community hospitals competitive and viable. The Legislature's goal was to provide better health care to Hawai'i's citizens by freeing the corporation's facilities from unwarranted bureaucratic oversight. However, the corporation appears to have pushed the limits of this flexibility and autonomy with respect to procurement and has not fully adhered to subsequent legislative changes to procurement laws.

Based on our review, it appears that the corporation was fully subject to the *Hawai'i Public Procurement Code* (the procurement code) during fiscal year 2006; however, the corporation did not appear to take appropriate action to ensure compliance with the procurement code. We were informed by management that the corporation was exempt from state laws governing procurement of health and human services during the period under review and continues to be exempt from such laws. However, based on our review, we discovered no evidence that the Legislature or the State Procurement Office (SPO) have ever granted such an exemption. The corporation also used lease-financing transactions that may have violated the procurement code and placed the State at unknown and unnecessary risk. Furthermore, we noted during our review that the corporation lacked a comprehensive capital asset management policy and did not have a uniform capital asset tracking system.

The corporation was subject to the procurement code during the period under review and continues to be subject to the procurement code now

Section 323F-7(a)(30), Hawai‘i Revised Statutes (HRS), as originally enacted in 1996, provided that the corporation “shall have, and exercise, the following duties and powers,” including:

Developing internal policies and procedures for the procurement of goods and services, consistent with the goals of public accountability and public procurement practices, but not subject to chapter 103D. However, where possible, the corporation is encouraged to use the provisions of chapter 103D; provided that the use of one or more provisions of chapter 103D shall not constitute a waiver of the exemption from chapter 103D and shall not subject the corporation to any other provision of chapter 103D.

This exemption from the procurement code was repealed by Section 37 of Act 216, Session Laws of Hawai‘i 2004, which deleted all language in the above paragraph following the words “procurement practices.” The repeal was effective January 1, 2005 and applied to the period under review.

The corporation informed us that the above repeal was subsequently reversed, and its procurement code exemption reinstated, by Act 290, Session Laws of 2007, which took effect on July 1, 2007. However, Act 290 redesignated the above paragraph as Section 323F-7(c)(30), HRS, and amended it to read as follows:

Developing internal policies and procedures for the procurement of goods and services, consistent with the goals of public accountability and public procurement practices, and subject to management and financial legislative audits; provided that the regional system boards shall be responsible for developing internal policies and procedures for each of their regional systems consistent with the corporation’s policies and procedures; and further provided that:

- (A) The regional system boards and the corporate board shall enjoy the exemption under section 103-53(e);
- (B) The regional system boards shall enjoy the exemption under chapter 103D; and
- (C) The corporation shall be subject to chapter 103D;

Thus, even as subsequently amended to read as set forth above, it appears that Chapter 103D, HRS, still applies to the corporation even today, and the corporation is legally obligated to comply with it.

Management conceded that, between January 1, 2005 and July 1, 2007, which includes the period under review, the corporation was required to comply with the procurement code; however, it continued to claim that the corporation was exempt from state laws governing the procurement

of health and human services. Management did not provide evidence that this claimed exemption was validated by the SPO or the Department of the Attorney General during the period under review. Furthermore, written correspondence subsequently received from the SPO and Attorney General was not consistent with management's claim of exemption.

The corporation determined unilaterally that it is exempt from health and human service procurement laws

Management asserts that it has always been and continues to be exempt from the requirements of Chapter 103F, HRS, *Purchases of Health and Human Services*, and accordingly admits that the corporation does not comply with these provisions. Management believes that the exemption is necessary to enable the corporation to provide timely services to patients in the best interests of the public, and obtained legal opinions from two law firms in support of its contention. However, for the reasons set forth below, we do not consider the opinions presented to support the expansive claim of exemption taken by management.

Chapter 103F, HRS, generally applies to public procurement of health and human services provided to Hawai'i's residents. When Chapter 103F, HRS, applies, it applies in lieu of Chapter 103D, HRS. Section 103F-101, HRS, states that it "shall apply to all contracts made by state agencies and may be used by county agencies to provide health or human services to Hawai'i's residents." Section 103F-102, HRS, defines an agency as "any department, authority, commission, council, board, committee, institution, legislative body, agency, or other establishment or office of the executive, legislative, or judicial branch of the State." Section 328F-2, HRS, states that "the Hawai'i health systems corporation . . . shall be a public body corporate and politic and an instrumentality and agency of the State." Thus, it appears that the corporation is subject to the provisions of Chapter 103F, HRS. This conclusion was corroborated by the SPO in the memorandum dated December 28, 2007 attached as Appendix A and our conversations with the administrator of the SPO.

To support its contention that Chapter 103F, HRS, does not apply to the corporation, management furnished us with copies of two legal opinions.

The first legal opinion, from Alston Hunt Floyd and Ing, was based on an understanding that "HHSC currently applies Chapter 103D procedures to its contracts for health care professionals." The law firm noted that Chapter 103F applies only to agencies who provide health and human services to targeted groups through "providers" who act "on the agencies' behalf," and noted that the corporation itself provides health and human services and thus cannot fulfill its mission by contracting

with others to act on its behalf. Finally, the law firm noted that the corporation's assumed compliance with Chapter 103D, HRS, results in full compliance with the competitive procedures of Chapter 103F, HRS; provides even greater protections against waste and abuse of public funds; and avoids conflicts with the Legislature's intended independence and community oversight of the corporation.

Even assuming that Chapter 103F, HRS, did not apply to the corporation, we found pervasive noncompliance with the provisions of Chapter 103D, HRS, which the Alston Hunt Floyd and Ing opinion makes clear, does apply. We do not believe the Alston Hunt Floyd and Ing opinion supports the proposition, apparently espoused by management, that the corporation is excused from complying with *both* Chapters 103D and 103F, HRS.

The second opinion, dated September 22, 2006, was not even addressed to the corporation, but rather to a service provider, and was from the law firm Lyons, Brandt, Cook and Hiramatsu. The issue dealt with in the second opinion was whether a contract extension that was executed by Clinical Laboratories of Hawai'i and the corporation in 2004 was valid and enforceable. Also, the opinion focused on the procurement code as it existed prior to January 1, 2005, which makes it irrelevant to the period under review.

In March 2007, we inquired with the SPO regarding the corporation's alleged exemption from Chapter 103F, HRS, and were informed that the SPO's position, at the time, was that the corporation was subject to that chapter. The SPO made a formal inquiry regarding this matter to the Department of the Attorney General on December 2, 2005 but did not receive a response until December 2007.

On December 28, 2007, the corporation received a memorandum from the SPO. This memorandum stated that the corporation is exempt from the provisions of Chapter 103F, HRS (but not Chapter 103D, HRS), when it provides health and human services that are directly related to the corporation's regular business activities through its employees, contractors, and independent medical staff, if an employer-employee relationship exists. This is because the corporation, rather than any third party provider, is providing the health or human services. However, the memorandum went on to state that if the health and human services are directly related to the corporation's regular business activities but an employer-employee relationship does not exist, then the services must be procured under the provisions of Chapter 103D, HRS. The SPO gave an example of laboratory services provided to the public in the corporation's health care facilities, and concluded that those services are related to the corporation's regular business activities but that there is no employer-employee relationship, such that Chapter 103D, HRS, would be

applicable. Finally, if the corporation contracts with a third party provider to provide health or human services on behalf of the corporation, and the services are not related to the corporation's regular business activities, the procurement would be subject to Chapter 103F, HRS. It is important to note that none of the contracts we reviewed qualified as an employer-employee relationship, nor are we aware of any analysis performed by the corporation to make a determination regarding this.

This SPO memorandum appears inconsistent with the proposition, advocated by management, that Chapter 103F, HRS, never has and never will apply to the corporation under any circumstance. Furthermore, this memorandum appears to conclude that provisions of the procurement code, either Chapters 103D or 103F, HRS, apply to the corporation even today, depending on the nature of the service provider arrangement. Thus we question management's apparent belief that the corporation is exempt from the procurement code such that it need not adopt procurement policies in compliance with state law.

Finally, we have serious questions regarding why management did not address this matter with the SPO, or perhaps with the Department of the Attorney General, at an earlier date. We understand that the administrator of the SPO is empowered, under Hawai'i Administrative Rules Sections 3-141-501 and 3-141-503, to grant waivers or exemptions of certain provisions of the procurement code. If this matter had been addressed with the SPO and the SPO believed that the law applied to the corporation but that its provisions as applied were inappropriate, inequitable or unfair, it could have granted an exemption or waiver to the corporation at the time. Instead, it appears that the corporation sought out opinions to support its own interests and preconceived views, leading to questionable policies and, as detailed in the following section, questionable practices and effects.

The corporation's procurement policies violate the procurement code

The corporation has not modified its procurement policies with respect to small purchases to comply with the procurement code. The procurement standards for small purchases are generally less stringent than the standards that apply to higher dollar contracts. For example, a small purchase may only require the solicitation of three written quotes, while a procurement transaction exceeding the small purchase threshold would be subject to a much more rigorous process, including public advertisement, receipt and review of formal proposals or bids, establishment of proposal/bid review committees, creation of formal contracts, and approval from the SPO. During the period under review, the procurement guidance in Section 103D-305, HRS, defined small

purchases for goods, services, or construction as those under \$25,000. Section 103F-405, HRS, also stated that small purchase procurements for health and human services may not exceed \$25,000. The corporation's internal procurement policy, during the period under review, considered procurement transactions under \$100,000 to be small purchases, \$75,000 more than the thresholds specified in the procurement code.

The corporation also contends that long-term contracts executed or in process prior to January 1, 2005, that contain automatic renewal or extension provisions continue to be valid since the corporation was not required to comply with the procurement code at the time these contracts were executed. Therefore, during fiscal year 2006, the corporation allowed certain contracts to be renewed automatically without determining whether the procurement code requirements for multi-term contracts (Section 103D-315, HRS) had been satisfied.

During our review we visited each of the corporation's facilities, noting that in general the corporation's procurement process was decentralized. Each of the corporation's 13 facilities was responsible for procuring goods and services that pertain to its own operations, while goods and services shared among facilities were procured by the corporate office. Based on our review, it is evident that the corporation lacks a comprehensive procurement policy that conforms to the procurement code and procurement personnel are inadequately trained. The corporation hired a procurement manager during fiscal year 2006; however, the decentralized procurement process and lack of a centralized contracts management system made it difficult for this individual to adequately monitor procurement activities across the system. A decentralized procurement function requires each facility to have procurement personnel that are knowledgeable about the procurement code and, more importantly, adequately trained to ensure all procurements comply with state laws and regulations.

The primary reasons for the differences between the corporation's internal procurement policies and the procurement code were due to management's belief that the corporation is exempted from Chapter 103F, HRS, and the fact that management was in the process of revising its internal procurement policies to comply with the various provisions of Chapter 103D, HRS.

The corporation has violated the procurement code

During fiscal year 2006, the corporation entered into 430 contracts worth nearly \$103 million (based on a listing provided by the corporation procurement manager). We tested a sample of 30 procurement transactions from this listing, noting 13 instances of noncompliance with the procurement code.

For the following two contracts, the corporation did not provide evidence (written or otherwise) that these contracts were awarded through a request for proposals, as required under Sections 103D-303(b), HRS. Issuing a request for proposals would ensure fair and open competition and prevent large contracts from being discretionarily awarded on any improper basis.

- | | | | | |
|----|---------|--------------|-------------------------|-----------|
| 1. | #06-328 | Clinical Lab | Laboratory services | \$150,000 |
| 2. | #06-162 | Fresenius | Extracorporeal services | \$100,000 |

The following contract was awarded as a small purchase despite the fact that the total contract value exceeded \$25,000, which violated Sections 103D-305, HRS, at the time of award.

- | | | | | |
|----|---------|-------------------------|---------------------------------------|----------|
| 3. | #06-617 | GoodMan &
Associates | Cardiovascular consulting
services | \$99,750 |
|----|---------|-------------------------|---------------------------------------|----------|

For the following contract, the corporation did not provide evidence (written or otherwise) that the contract would serve the best interests of the governmental body by encouraging effective competition or otherwise promoting economies in procurement, in accordance with Section 103D-315(b)(2), HRS, for multi-term contracts. The contract was for the five-year period January 1, 2006 to December 31, 2010 and has been automatically renewed in five-year increments since 1986, and will continue to be renewed in five-year increments unless terminated by the corporation.

- | | | | | |
|----|---------|------|----------------------|----------|
| 4. | #06-164 | KONE | Elevator maintenance | \$75,000 |
|----|---------|------|----------------------|----------|

For the following three contracts, the corporation did not provide evidence (written or otherwise) of an endorsed certification by the comptroller or other authorized individual to ensure sufficient funds existed to cover the amount of the awarded contract in accordance with Section 103D-309(a), HRS. The corporation also did not provide evidence (written or otherwise) that the contractor submitted cost or pricing data, or a certification confirming the data submitted was accurate, complete and current, in accordance with Section 103D-312(a), HRS, which is designed to ensure that all costs billed to the corporation are accurate.

- | | | | | |
|----|---------|---------------------------|-------------------------------|-----------|
| 5. | #06-242 | Automated
Technologies | Software products | \$159,582 |
| 6. | #05-073 | Powell
Goldstein, LLP | Legal and consulting services | \$450,000 |
| 7. | #03-004 | Otis Elevator
Co. | Elevator maintenance | \$889,891 |

For the following two contracts, the corporation did not provide evidence (written or otherwise) that the chief procurement officer (CPO), head of the purchasing agency, or a designee, made a written determination that the proposed contractors' accounting systems would permit timely development of all necessary cost data in the form required by the specific contract types contemplated, and that the proposed contractors' accounting systems were adequate to allocate costs in accordance with generally accepted accounting principles, which is a violation of Section 103D-314, HRS, designed to ensure that all costs billed to the corporation are properly allocated.

8. #06-138	Managed Resources	Consulting services	\$500,000
9. #05-073	Powell Goldstein, LLP	Legal and consulting services	\$450,000
10. #06-272	Pacific Medicaid Services, Inc.	Financial and insurance services	\$300,000

For the following two contracts, the corporation did not provide evidence (written or otherwise) that the "Notice of Amendment to Sole Source Contract" was posted in an area accessible to the public for at least seven days prior to any approval action, in accordance with Section 103D-306(a), HRS, designed to ensure that all amendments to noncompetitive agreements are communicated to the public.

11. #05-073	Powell Goldstein, LLP	Legal and consulting services	\$450,000
12. #03-004	Otis Elevator Co.	Elevator maintenance	\$889,891

For the following contract tested, the corporation did not provide evidence (written or otherwise) that: a) the CPO made a written determination that the contract type selected (cost-plus-reimbursement) was less costly than any other type of contract, or that it was impracticable to obtain the goods, services or construction required except by means of such a contract; b) notice was provided to the head of the compliance audit unit, president of the Senate, speaker of the House of Representatives, and the chairpersons of the Senate Ways and Means and House Finance committees; or c) such notice was conspicuously posted in an area accessible to the public in the office of the CPO and available for public inspection during normal business hours, all of which are violations of Sections 103D-313(b) and (c), HRS. The contract was a cost-plus-reimbursement contract. Cost-plus-reimbursement contracts can be amended, and the total contract value is unknown, which exposes the corporation to potentially expending substantially more than anticipated.

13. #05-073 Powell Legal and consulting services \$450,000
Goldstein, LLP

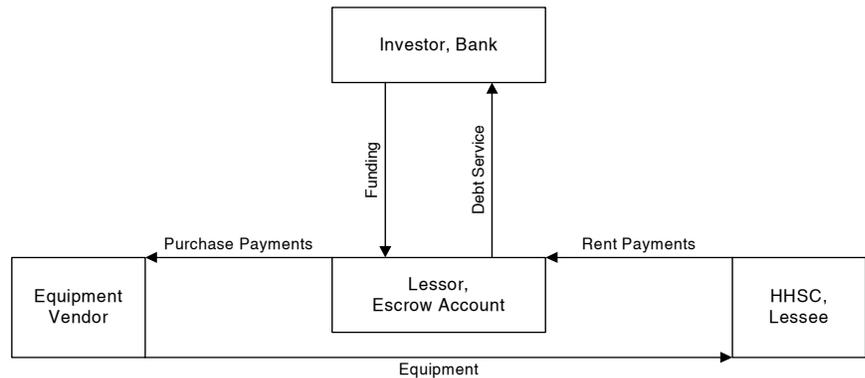
The corporation was also initially unable to provide us with a complete and accurate listing of procurement transactions entered into during fiscal year 2006 since each of the corporation's facilities entered into their own procurement contracts and the corporation lacked a centralized procurement system. The corporation's decentralized procurement system required each facility to prepare individual procurement listings which caused delays in locating specific contract files. To test the completeness of the listing provided to us by the corporation procurement manager, we selected 25 contracts maintained in the Contract Management Office and attempted to trace the contracts selected to the contract listing originally provided to us, and determined that the listing was incomplete. We requested management to update its listing and subsequently tested 25 additional contracts without exception.

The procurement code promotes the effective and efficient procurement of goods and services by state agencies, and the SPO has clearly documented guidelines governing the procurement of goods and/or services in accordance with state laws. Failure to comply with the procurement code is a violation of state law and could lead to the invalidation of awarded contracts or other negative consequences. Since its inception, the corporation has always been required to develop "internal policies and procedures for the procurement of goods and services, consistent with the goals of public accountability and public procurement practices" [Section 323F-7(c)(30), HRS]; however, the significant findings revealed by our review raise serious questions as to the corporation's awareness of, compliance with, or commitment to this duty. We also noted that individuals responsible for the procurement of goods and services do not have a comprehensive understanding of the procurement code, which is another reason that the corporation's procurement policy was not in compliance with the code. Furthermore, the practice of awarding non-competitive contracts may fuel public speculation that contracts with state entities are awarded on a less than even playing field, rather than economically and in the public interest.

The corporation's use of lease financing exposes the State to additional risks and uncertainties

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 may legally own the leased assets, a security interest remains with the lessor until all lease payments are made. Exhibit 2.1 illustrates the transaction flow of a municipal financing lease.

Exhibit 2.1 Transactional Flow of a Municipal Lease Arrangement



Source: Hawaii Health Systems Corporation

The corporation does not comply with the procurement code when procuring equipment through these types of lease financing transactions. Instead, the corporation follows its internal procurement policies and procedures, which do not conform to state law, and requires approval by the chief operating and financial officer and the board of directors for lease financing transactions in excess of \$500,000 only. The corporation contends that lease financing transactions are exempt from the procurement code since this type of transaction allows the corporation to procure equipment at favorable interest rates when the subject items are needed, avoiding delays involved with requesting moneys through the legislative process.

We inquired about whether the State of Hawai'i was contingently liable for lease financing transactions in the event of default by the corporation; however, we were informed by management officials that in their opinion, the State was not contingently liable for events of default by the corporation. We tested all ten of the lease agreements entered into during fiscal year 2006 and noted no explicit provisions naming the State as a guarantor; however, we also noted no provisions explicitly indemnifying the State. Although leasing arrangements may be a valid form of financing capital asset acquisitions, these types of arrangements could be used as a means to circumvent the procurement code and unnecessarily saddle the corporation, and indirectly the State, with significant debt. Over the next 12 years, the corporation expects to pay approximately \$53 million in capital lease payments. If the corporation were to default on its lease financing obligations it would likely have to seek financial assistance from the State. Thus, although the State is not

explicitly named as a guarantor in lease financing agreements, the State may be held contingently liable in the event of the corporation’s default as an agency of the State.

The corporation lacks a uniform capital asset tracking system

The corporation lacks a uniform capital asset tracking system, resulting in each facility being responsible for tracking its own assets. The department heads of the various facilities are responsible for performing an annual physical inventory of capital assets within their department. However, most department heads are not familiar with the requirements over capital asset management as outlined in the procurement code. Further, the performance of an annual physical inventory is not considered a priority for the corporation, evidenced by the fact that the corporate office did not perform an annual physical inventory of capital assets as of June 30, 2006 as required under Section 103D-1206, HRS. During our examination, we noted significant differences in the level and quality of capital asset tracking processes among the various facilities. Certain facilities utilize specialized accounting software solutions such as Asset Expert or Fixed Asset Software (FAS), while other facilities utilize simple programs like Microsoft Excel.

We attempted to validate the existence of 100 capital asset items located across the Hilo Medical Center (HMC), Maui Memorial Medical Center (MMMC), Kona Community Hospital, and Leahi Hospital. We noted the following:

- HMC was unable to locate the following five capital assets selected for testing:

Description	Acquisition Date	Acquisition Value	Net Book Value
1. Machine X Ray Diag. GE KX24	07/01/1962	\$24,645	\$0
2. Ultrasound Unit, Diagnostic, s/n 9612-C22027	05/26/2000	\$92,300	\$0
3. X-Ray Film Developer	05/21/2001	\$134,666	\$49,097
4. Chest X Ray Sys MEDRAD Mark IV Angio	12/01/1985	\$73,389	\$0
5. MRI Equipment	05/15/1995	<u>\$1,695,000</u>	<u>\$0</u>
Total		<u>\$2,020,000</u>	<u>\$49,097</u>

- Seven items at MMMC and HMC did not have identification tags, which are necessary to identify and monitor capital assets. Thus, we were unable to validate the existence of the following seven items:

Description	Acquisition Date	Acquisition Value	Net Book Value
1. Diesel Fuel Tank	06/30/2001	\$280,811	\$210,608
2. Fire Suppression Laundry	03/01/2005	\$372,859	\$348,002
3. Patient Monitor	08/07/2000	\$255,694	\$127,847
4. Physiological Monitor— UV 1050	09/30/2003	\$229,863	\$139,559
5. Telemetry Unit Cardiac— Digital System	02/29/2004	\$386,497	\$208,086
6. Stretcher, Hydraulic— Eye Gurney	08/28/2003	\$28,032	\$16,686
7. Ureteroscope, ACMI Mod, #DUR-8, s/n 8D3031	01/25/2005	\$5,981	\$4,286
Total		<u>\$1,559,737</u>	<u>\$1,055,074</u>

Each of the facilities visited claimed to have performed an annual physical inventory; however, if this were true, all items that we selected would have been accounted for as existing or missing. We also noted that MMMC and HMC lacked formal procedures to ensure that identification tags were affixed to capital assets at the point of receipt. Conversely, we noted instances where two identification tags were affixed to a single asset: a state decal used by the accounting or equipment management staff and a separate biomedical equipment control number used by the medical staff. The lack of identification tags or use of multiple identification tags on the corporation's capital assets increases the risk of misplaced, lost, or possibly stolen assets. Furthermore, the corporation's decentralized monitoring and tracking system makes it difficult for the corporation to ensure that capital asset additions, transfers, and disposals are recorded in an accurate and timely manner. Based on the results of our existence testing, missing and/or unidentified capital assets at HMC and MMMC resulted in an overstatement of the corporation's total assets as of June 30, 2006 by approximately \$1.1 million.

The corporation maintains that it did not have the funds available during any fiscal year to purchase a system-wide capital asset tracking system. That said, capital assets represent the corporation's single largest asset category, amounting to \$221,454,648 at June 30, 2006, and many items have cost bases in excess of \$10,000, making them highly susceptible to misappropriation.

Section 103D-1206, HRS, states:

The chief procurement officers for their respective jurisdictions, the administrative heads of the executive departments, and all other persons, offices, and boards of a public character which are not by law under the control and direction of any of the officers specifically named in this section, before September 16 of each year, shall prepare and file with the administrator of the state procurement office an annual inventory return of state property in the possession, custody, control, or use of the officer making the return, or of the department or office of the government over which the officer presides.

Although an annual inventory report was filed, it appears that the report was inaccurate.

The procurement code was established to foster broad-based competition in the procurement process in order to ensure that public moneys are spent in a prudent manner. Sole source contracts and “small purchase” contracts, where less oversight was traditionally exercised, were particularly prone to charges of waste and cronyism. The corporation, an agency and instrumentality of state government and funded by taxpayer dollars, was clearly subject to the procurement code during the period of our review and largely ignored its responsibility to adhere to the procurement code. Furthermore, despite explicit statutory language providing that “the corporation shall be subject to chapter 103D,” it continues to spend taxpayer money according to noncompliant policies. Because the corporation is heavily reliant on public funds to operate, it is imperative that its procurement practices comply with the procurement code.

Recommendations

We recommend to the corporation that it review, assess, and revise its internal procurement policies and practices to comply with the procurement code to ensure the prudent use of public monies.

We further recommend that the corporation take the following actions with respect to capital assets:

- Develop and implement a formal capital asset tracking policy. The policy should address the initial input of capital assets into the tracking system, ongoing physical tracking of existing capital assets, and procedures for the disposal and/or removal of capital assets. The policy should be uniformly and consistently followed at all facilities.

- Procure and implement an automated capital asset inventory system. The system should enable the corporation to input the assets upon receipt and automatically generate identification tags. The system should also enable the corporation to track the location of its assets at any given point in time, and enable the corporation to generate capital asset inventory reports by location to assist with the annual physical inventory process.
- Consider involving the internal audit function with the ongoing monitoring of the existence of capital assets.

The Corporation's Inattention to Information Technology Management Exposes Its Sensitive Information to Unnecessary Risk

The corporation's information technology (IT) organizational structure, which can be best described as loosely centralized, is organized into five regions: Kona, Hilo, Kaua'i, Maui and O'ahu. The corporate office provides overarching guidance to the regions on systems and software standards and policies and procedures, and maintains the wide area network and telecommunication connectivity for all facilities. Each region is assigned an IT leader, who is responsible for managing IT resources, end-user support, IT staffing, and systems and software maintenance at the facilities within the region.

Based on our procedures, it is evident that the corporation's current IT practices expose the corporation to risks of unauthorized access to sensitive data, such as patient medical records and financial data. The corporation has outsourced a majority of its core IT activities to third party vendors and has placed significant reliance on these vendors to ensure that the corporation's systems and applications are secure and operating properly. Further, insufficient monitoring of system and database activity increases the risk of inappropriate data manipulation/loss, which could result in a material misstatement of the corporation's financial statements.

User access and terminated user reviews should be improved

We noted that the corporation does not review the propriety of user access or the existence of terminated users within its systems on a regular basis. While a process exists for the human resources department to notify the IT department of terminated users, there is an infrequent process to review critical systems for accounts that may have been missed or overlooked via this process. A formal user access and terminated user review is typically performed once, just prior to the corporation's annual financial statement audit. Infrequent reviews of existing user access for propriety and the untimely removal of terminated users from critical applications pose a security threat. This could result in inappropriate access and/or manipulation of sensitive data, such as

patients' social security numbers, phone numbers, and medical histories, all of which are required to be protected under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). This act requires health care providers to maintain reasonable and appropriate safeguards that ensure the integrity and confidentiality of medical information. Additionally, the corporation's financial accounting modules are also exposed to manipulation by unauthorized users, which could result in material misstatements to the corporation's financial statements. The corporation claims that staffing constraints do not allow the IT department to perform reviews on a more frequent basis. Best practice suggests that user account access be reviewed on at least a semi-annual basis and terminated user access be reviewed at least quarterly on all systems and applications.

Inadequate controls exist over third party access to systems and applications

The corporation contracts with third party vendors for systems support and application maintenance. For example, one vendor provides systems maintenance and support for the Series billing system. In addition, a third party contractor serves as the corporation's database administrator (DBA).

Upon further inquiry with the corporation's IT management, we noted the following:

- Both vendors have access to the corporation's systems and applications at all times via a virtual private network (VPN).
- The corporation does not maintain logs of vendor activity within its systems and is therefore unable to monitor the propriety of the activities performed by its vendors within the application or at the system level.
- Although database activity is logged for the Series application, there is no formal monitoring of the log, and the DBA vendor has the ability to modify and/or delete the log.

The corporation has essentially turned over the keys to its information systems to third parties and has provided the vendors full access to the corporation's systems, making it extremely difficult for the corporation to monitor vendor activity or prevent vendors from inappropriately accessing and/or modifying sensitive data. Moreover, the vendors do not provide Type II SAS 70 reports that would result from an examination performed by independent auditors in accordance with Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations*. Without a Type II SAS 70 report from the vendor, which would provide an independent opinion regarding the vendors' description, design, and operating effectiveness of

internal controls, the corporation cannot ensure that controls over change management, user access, segregation of duties, and direct data access are in place and operating effectively. The corporation lacks the system resources and tools necessary to enable its IT department to effectively and efficiently monitor vendor activity. While the corporation contends that staffing constraints do not allow the IT department to monitor vendor activity within the corporation's systems, best practice suggests that third party access to systems be given on an "as needed" basis. Such access should be closely monitored during the service period and revoked immediately after completion of the service.

The corporation does not monitor activity within its operating system and database

We noted that the corporation does not monitor activity within its operating system or database for unauthorized access and/or changes on a regular basis. In addition, the corporation lacks the system resources and tools necessary to enable the IT department to effectively and efficiently monitor operating system and database activity. While the corporation contends that staffing constraints do not allow the IT department to monitor activity within the corporation's systems, the corporation could implement automated auditing and logging functions on sensitive production systems. This could enable the IT department to track any user activity and identify potentially inappropriate access and/or changes in a timely manner. The lack of regular reviews of operating system and database activity poses a significant security threat. Unauthorized access or changes to the corporation's operating systems and databases could lead to the untimely discovery of fraudulent activity and/or the manipulation of sensitive data, which could result in the corporation's noncompliance with HIPAA and material misstatements to the corporation's financial statements.

Recommendations

The corporation should take the following actions:

- Ensure that adequate resources are devoted to more frequent reviews of user account access and terminated user access. User lists should be generated and distributed to department heads for review on a quarterly basis, and department heads should communicate changes and/or removals to the IT department for corrective action in a timely manner.
- Grant third party access to systems and applications only on an "as needed" basis.
- Restrict third party access to those systems and/or functions within systems that they are working in to prevent possible inappropriate access or modification to sensitive data.

- Closely monitor the changes and activities of third party contractors during the service period through utilization of available automated system auditing tools.
- Immediately revoke third party access to systems upon completion of services.
- Implement automated auditing and logging functions on its systems in order to monitor unauthorized activity. Instances of unauthorized access and/or activity should be investigated and resolved in a timely manner.

Not All of the Corporation's Facilities Have Established Policies Regarding Billings, Collections, and Receivables, and Such Policies, When Established, Are Not Always Adhered To

We visited each of the corporation's facilities, noting that the corporation's current billing and cash receipting processes are decentralized. Each facility is responsible for its own billing, collections, and financial reporting. Based on our testing, it appears that the various facilities do not record revenues and receivables in accordance with generally accepted accounting principles (GAAP) for healthcare organizations. While certain facilities lack the necessary staffing to effectively perform even the most basic business functions like billing and collection, the corporation, as a whole, does not have an effective automated billing system with the capability to appropriately apply third-party reimbursement rates.

The corporation's billing and collection system is not conducive to producing GAAP financial statements

Insurance information is generally collected from patients when patient accounts are created in the billing system. This is done either prior to treatment or upon discharge, so the corporation should know what rates it may claim from its various third party payors prior to billing. Services rendered to and supplies used for patients are charged to patient accounts, at which time the billing system records patient revenue and an unbilled patient receivable using standard facility rates. As is common in the healthcare industry, facilities often are unable to bill and fully recover patient charges at standard rates due to the existence of contractual rates stated in third-party payor agreements. It is inappropriate for the corporation to record the gross amount of revenues and receivables if third-party payor agreements exist—revenues and receivables should be recorded less the amount of these contractual adjustments.

Currently, each of the corporation's facilities submits patient claims for reimbursement to third party payors. Claims related to long-term care patients are submitted on a monthly basis, while all other claims are submitted upon patient discharge. Once a claim is submitted, the billing system automatically reclassifies the unbilled patient receivable to a billed patient receivable. At this point, GAAP requires revenues to be recorded less the amount of contractual adjustments; however, the corporation records the entire amount as revenue. At the end of each month, each facility estimates an allowance for contractual adjustments and bad debts based on historical collection experience. This allowance is supposed to represent the difference between a facility's standard rates and the contractual rates under third-party payor agreements, but in reality is based only on collection experience and not on contractual rates. An adjustment for contractual rates is made only upon receipt of reimbursement from the third party payor. The corporation's current practice of not estimating contractual adjustments on a transaction-by-transaction basis could result in a material misstatement of both receivables and revenues at a given point in time. In addition, the corporation's current practice commingles the analysis of contractual adjustments with bad debts. While bad debts are subject to estimation by management, contractual adjustments are pre-determined and therefore known. Exhibit 2.2 compares the corporation's revenue cycle with a revenue cycle in accordance with GAAP:

Exhibit 2.2
Comparison of Patient Revenue-Cycles: HHSC vs. GAAP

	Process description		Revenues reported		
	HHSC's current revenue cycle	GAAP revenue cycle	HHSC's current revenue cycle	GAAP revenue cycle	HHSC cumulative overstatement
Step #1: Patient admitted	Hospital records patient's insurance information and patient treated.	Hospital records patient's insurance information and patient treated.	\$0	\$0	\$0
Step #2: Hospital submits claim to insurance provider	Claim submitted to insurance provider and hospital records services provided at standard rates (\$1,000).	Hospital records services provided at standard rates (\$1,000). Difference between standard rate (\$1,000) and contractual rate (\$700) is recorded as a reduction to net revenues and receivables (\$300).	\$1,000	\$700	\$300
Step #3: Month end adjustment	Hospital estimates collection rates (80%) based on historical data. Difference between standard rate (\$1,000) and collection rate (\$800) is recorded as a reduction to net revenues and receivables (\$200).		\$800	\$700	\$100
Step #4: Reimbursement from insurance provider	Insurance provider pays hospital based on contract rate (\$700). Hospital records difference between contractual rate (\$700) and estimated collection rate (\$800) as a further reduction of revenues (\$100).	Insurance provider pays hospital based on contract rate (\$700)	\$700	\$700	\$0

Source: Analysis prepared by Accuity LLP based on HHSC's revenue process. Note that dollar amounts are hypothetical.

Each facility is responsible for receiving and recording cash payments from patients and reimbursements from third-party payors. Actual payments received are normally less than the total patient receivable balance in the billing system, with the difference being recorded as a reduction of the previously established allowance for contractual adjustments. There is no procedure to verify whether the actual cash receipt corresponds to the contractual rates under third-party payor agreements, resulting in potential under or over reimbursement.

Many of the problems cited are attributable to the corporation's inability to upload third-party payor rates into its billing system to automate the posting of contractual adjustments. This system limitation makes it difficult for the corporation to accurately and completely record revenue and receivable transactions, net of contractual adjustments in accordance with GAAP; assure that the corporation is reimbursed at rates that correspond to third-party payor agreements; adequately evaluate the collectibility of outstanding patient receivables; and adequately evaluate the profitability of individual facilities on an interim and annual basis.

Untimely submission of patient claims resulted in over \$200,000 of lost revenues

In fiscal year 2007, Ka'u Hospital, Hale Ho'ola Hamakua, and Kula Hospital wrote off receivables from third-party payors, aggregating approximately \$204,000, primarily from Medicare and Medicaid, all of which were outstanding greater than 365 days. The receivables were written-off based on communications from the third-party payors stating that the patients' benefits had expired due to the facilities' failure to submit the claims in a timely manner. Medicare claims must be filed within one full calendar year following the date of service. For example, if services were provided on March 22, 2005, the claim for those services must be submitted to Medicare for payment by December 31, 2006. Medicaid claims must be submitted to Medicaid for payment within 12 months after the date of service.

The aforementioned facilities contend that there was inadequate staffing to ensure that claims were appropriately prepared and submitted to third-party payors in a timely manner. In addition, staffing constraints resulted in the untimely follow-up on rejected claims and resubmission of the claims to third-party payors prior to expiration. Inaccurate and untimely submission of claims to third-party payors could result in misstatement of the corporation's financial statements and lead to additional foregone revenues for services rendered.

The corporation does not record cash receipts/contractual adjustments in a timely manner

We selected a sample of 280 outstanding patient receivable balances representing 2.60 percent of the corporation's gross receivables at June 30, 2006. We noted the following:

1. A \$2,611 receivable that was outstanding for greater than 365 days and determined to be 100 percent uncollectible as of June 30, 2006. However, in May 2006, a \$469 payment was received but not recorded by the Ka'u Hospital business office until July 2006.
2. A \$4,282 contractual adjustment associated with a payment received in September 2005 was not recorded by the Maluhia business office until February 2007, resulting in an overstatement of receivables by \$4,282 as of June 30, 2006.

The aforementioned facilities do not have procedures in place to ensure that cash receipted by the business office and contractual adjustments are posted to the billing system in a timely manner. Based on the testing performed, all other facilities appeared to have procedures in place to ensure that payments are posted to the billing system in a timely manner. As all of the corporation's business offices have adequate segregation of duties surrounding the cash receipting process, a reconciliation of payments received to the payments recorded in the billing system would ensure that all payments/contractual adjustments are recorded in a timely manner.

Payments that are not recorded in the billing system upon receipt have a higher risk of being misplaced or misappropriated, which directly affects the corporation's financial position and results of operations. Additionally, a misplaced payment creates inefficiencies within the business office, as staff will need to investigate outstanding receivables and locate the misplaced payment. If not found, the corporation may need to request another payment, or incur a loss if the third-party payor or patient refuses to make another payment.

The corporation does not record payments for long-term care patients to the appropriate patient cycles

Maluhia Hospital has an automated billing system for long-term care patient services. The billing system accumulates patient charges and automatically generates invoices to the third-party payors or the patients on a monthly basis. In order for accounts receivable to be properly stated, payments need to be applied to the proper billing cycle. For example, if a payment is applied to a billing cycle that was previously paid, it will result in a credit (negative) balance for the previous billing cycle, while a receivable for the current billing cycle will remain outstanding.

In general, credit (negative) receivable balances represent prepayments or overpayments that should be reported as a liability. If the credit

balances were attributable to cash receipts applied to the wrong billing cycle, both receivables and liabilities would be overstated. Additionally, since the allowance for uncollectible receivables and contractual adjustments is partly based on the outstanding receivables balance, the inappropriate overstatement of receivables would also lead to an overly conservative allowance.

We reviewed the aged accounts receivable report as of June 30, 2006 for Maluhia, noting a credit balance of approximately \$277,000, comprised of 312 patient accounts. The Maluhia business office was unable to determine whether these credit balances resulted from prepayments, overpayments or the misapplication of payments to the wrong billing cycle. A similar review of the aged accounts receivable report as of June 30, 2006 for the other facilities did not yield any additional instances of improper payment applications.

Generally accepted accounting principles requires payments received in advance of goods or services provided to be reported as a liability. Generally accepted accounting principles also requires that management provide an allowance for doubtful accounts and contractual adjustments based on management's best estimate of the collectibility of outstanding receivables.

Recommendations

The corporation should:

- Consider utilizing a billing system that allows third-party payor rates to be uploaded and automatically applied to patient accounts at the time services are rendered in order to improve the accuracy of financial reporting. In addition, the corporation should consider centralizing its billing and cash receipting functions to ensure accurate and timely submission of claims reimbursements to third-party payors and posting of cash receipts in a standard manner.
- Ensure that all claims for reimbursement are properly prepared and submitted to third-party payors in a timely manner. Emphasis on proper preparation of claims should reduce the number of rejections from third-party payors, improve the timeliness of cash collections, reduce credit losses, and alleviate time burdens on business office staff.
- Perform a daily reconciliation of all payments received to payments posted to the billing system, which will ensure that all payments/contractual adjustments are recorded in the billing system in a timely manner.

- Ensure that cash receipts are posted to the proper billing cycle. The nature and cause of credit balances in individual patient accounts should be investigated and resolved on a monthly basis.

Lack of Management Cooperation Resulted in the Delayed Completion of the Engagement and Inability To Opine on the Corporation's Financial Statements

As a government agency and as a recipient of public funds, the corporation is subject to financial examination by the Office of the Auditor (State Auditor), as provided in Section 23-5(a), HRS. In an attempt to perform a review of the corporation's financial statements and certain agreed-upon procedures, the State Auditor hired a contract auditor to perform the financial statement review and agreed-upon procedures as of and for the year ended June 30, 2006. However, the contract auditor encountered a general lack of cooperation from corporation management, significantly delaying the completion of the engagement and preventing the contract auditor from opining on the corporation's financial statements and including those statements in this report.

Lack of communication and cooperation by the corporation delayed the commencement of the engagement by four months

Based on discussions that took place at an entry conference on July 21, 2006 between the contract auditor, representatives from the State Auditor, and members of the corporation's management and the audit committee, it was agreed that the contract auditor would begin the review of the corporation's financial statements in August 2006, with an expected completion date of January 2007. On August 2, 2006, the contract auditor sent the corporation controller a detailed listing of all schedules needed for the financial statement review. However, the corporation controller did not respond to the contract auditor's request or even acknowledge that the listing was received by the corporation.

On August 17, 2006, the contract auditor sent an email to the chief operating and financial officer (COO/CFO) and corporation controller to set a start date for fieldwork. However, the corporation did not respond to the contract auditor until September 25, 2006, more than a month after the contract auditor first contacted the corporation, and the response provided by the COO/CFO was an inquiry related to one of the schedules requested by the contract auditor, rather than a confirmation of a start date for fieldwork. On November 20, 2006, the contract auditor sent another email to the corporation controller to request the dates that fieldwork could commence at the corporation's various hospital facilities. The contract auditor sent another email to the COO/CFO and corporation controller on November 27, 2006, since a response was not received to the email that was sent seven days earlier.

The contract auditor finally commenced field work on December 4, 2006, approximately four months after the engagement was initially scheduled to begin. On December 4, 2006, representatives from the contract auditor met with the corporation controller to discuss the listing of schedules that were requested on August 2, 2006. One of the items requested was the corporation's internal policy regarding conflicts of interest. However, despite the contract auditor's multiple attempts to request this policy from the corporation via email, phone conversations, and in-person contact with various corporation personnel, including the corporation's controller, general counsel, and director of human resources, the corporation did not provide this policy to the contract auditor until January 24, 2008, more than a year from when it was originally requested.

Delayed, incomplete, or non-, responses by the corporation contributed to our inability to attest to the accuracy or fair presentation of the corporation's financial statements

From December 2006 through February 2007, the contract auditor performed fieldwork at the corporation's various facilities. On March 19, 2007, the contract auditor sent the corporation controller an email requesting explanations for fluctuations that were noted in the corporation's financial statements for the year ended June 30, 2006. The contract auditor made numerous attempts to obtain these explanations from the corporation controller and COO/CFO—including emails sent on August 1, 2007, August 16, 2007, and again on November 23, 2007—with the final email request coming on December 12, 2007. However, neither the corporation controller nor the COO/CFO provided responses to the contract auditor's inquiries.

From May through October 2007, the contract auditor made numerous attempts to contact the corporation controller and COO/CFO via phone calls and email to seek answers to additional questions raised by the State Auditor regarding the corporation's financial statements. The questions raised were related to the corporation's \$34 million liability to the State and \$26 million in state support received for capital projects.

However, despite these numerous attempts, management officials generally did not respond to these specific inquiries and when they did, the responses provided were either incomplete or evaded the questions that were posed. For example, on June 6, 2007, the contract auditor emailed the corporation controller to discuss the questions; however, no response was forthcoming. On June 8, 2007, the contract auditor again requested explanations to the questions raised by the State Auditor. On June 10, 2007, the COO/CFO responded that the corporation was in the process of investigating the answers to those questions. However, throughout July 2007, the corporation failed to provide a response, prompting the contract auditor to send another email on August 1, 2007, and then again on August 16, 2007, to the corporation controller and COO/CFO requesting the status of their investigation. On August 16,

2007, the COO/CFO provided a brief, unelaborated response, further demonstrating that the corporation was either unwilling or unable to provide the contract auditor with explanations or background information related to the questions posed.

As management did not provide adequate explanations to these inquiries and the fluctuations previously mentioned, the contract auditor was unable to form any conclusions on these matters or complete all procedures required under sections 100.29 and 100.31 of the American Institute of Certified Public Accountants (AICPA) professional standards for reviews of financial statements, resulting in a review report not being issued and the delayed completion of the engagement.

Corporation management refused to provide representation as to the accuracy of their own financial statements

A standard procedure of any financial statement review is to have management sign a representation letter acknowledging its responsibility for the fair presentation of its financial statements in conformity with GAAP. However, corporation management refused to sign the representation letter unless it was provided with information unrelated to the representation letter.

On May 16, 2007, the contract auditor requested management provide a signed representation letter acknowledging management's responsibility for the fair presentation of the corporation's financial statements in conformity with GAAP, as required by AICPA professional standards applicable to reviews of financial statements. On June 12, 2007, the COO/CFO sent a letter to the contract auditor explicitly stating the corporation's refusal to sign the representation letter or acknowledge management's responsibility for the corporation's financial statements reviewed by the contract auditor. The COO/CFO's primary argument was that the corporation would not have an opportunity to review the financial statements and all related documents prior to its issuance – particularly the internal control findings noted by the contract auditor. On June 19, 2007, the contract auditor sent an email to the COO/CFO to clarify that the corporation would be given an opportunity to respond to any findings that were to be included with the financial statements in the State Auditor's report.

After a June 25, 2007 conference call involving members of the corporation's management, the contract auditor, and the State Auditor, management officials indicated they would sign the representation letter after reviewing a draft of the financial statements after the contract auditor explained that the representation letter applied only to the financial statements and not to any internal control findings. Based on this understanding, the contract auditor worked with the corporation to resolve concerns regarding the content of the representation letter; however, management officials still refused to sign the letter unless they

were allowed to review the internal control findings. On November 14, 2007, the contract auditor sent the COO/CFO and corporation controller the revised representation letter that related only to the corporation's financial statements. On November 16, 2007, the contract auditor sent the COO/CFO and corporation controller a draft of the corporation's financial statements to review. On November 26, 2007, the corporation controller sent the contract auditor a list of changes that needed to be made to the financial statements. The contract auditor then made the suggested changes and sent the revised financial statements back to the COO/CFO and corporation controller for their final review on November 30, 2007, along with a request to have management provide updates to several footnotes to the financial statements. However, the corporation did not respond to the contract auditor's request; did not provide updates to the footnotes to the financial statements for events occurring subsequent to June 30, 2006; nor was a signed representation letter provided, despite the fact that it was explained to management that the representation letter would pertain only to the financial statements.

As management failed to furnish the contract auditor with a signed representation letter and did not provide adequate explanations to questions related to its financial statements, the contract auditor was unable to complete its review procedures or issue a review report on the corporation's financial statements. Section 100.32 of the AICPA's professional standards for reviews of financial statements states that "written representations are required from management for all financial statements and periods covered by the accountant's review report." Consequently, the corporation's financial statements are excluded from this report.

Recommendation

The corporation's lack of cooperation prevented the State Auditor and contract auditor from discharging their examination duties as granted under Section 23-4, HRS. In the future, the corporation should provide more cooperation in audits performed by or on behalf of the State Auditor.

The Corporation's Financial Statements Excluded \$4 Million In Bond Fund Appropriations

During our financial statement review and agreed-upon procedures of the corporation, we identified an accounting error in the corporation's basic financial statements as of and for the year ended June 30, 2006, due to the lack of oversight by fiscal management over the corporation's MBP 430 report prepared by the Department of Accounting and General Services ("DAGS"). The corporation's MBP 430 report excluded allotments for the following appropriations that belong to the corporation:

- B-05-412
- B-05-413
- B-05-414
- B-05-415
- B-05-416

The omission of these appropriations resulted in a \$4.0 million understatement of the corporation's reported assets (Due from State of Hawai'i) and net assets in the consolidated statement of net assets as of June 30, 2006 and a \$4.0 million understatement of general appropriations revenues from the State of Hawai'i and change in net assets in the consolidated statement of revenues, expenses, and changes in net assets for the year ended June 30, 2006.

The following table reconciles the corporation's Due from State of Hawai'i and net assets at June 30, 2006, as previously reported, to the proper balances at June 30, 2006:

Due from the State of Hawai'i at June 30, 2006, as previously reported	\$-
Adjustment for allotments improperly excluded by the corporation	4,013,827
Proper Due from State of Hawai'i balance at June 30, 2006	<u>\$4,013,827</u>
Net assets at June 30, 2006, as previously reported	\$142,760,065
Adjustment for allotments improperly excluded by the corporation	4,013,827
Proper net assets balance at June 30, 2006	<u>\$146,773,892</u>

The following table reconciles the corporation's general appropriations revenue from the State of Hawai'i and change in net assets for the year ended June 30, 2006, as previously reported, to the proper general appropriations revenue from the State of Hawai'i and change in net assets for the year ended June 30, 2006:

General appropriations from the State of Hawai'i for the year ended June 30, 2006, as previously reported	\$32,280,041
Adjustment for allotments improperly excluded by the corporation	<u>4,013,827</u>
Proper general appropriations from the State of Hawai'i for the year ended June 30, 2006	<u>\$36,293,868</u>
Increase in net assets for the year ended June 30, 2006, as previously reported	\$25,520,758
Adjustment for allotments improperly excluded by the corporation	<u>4,013,827</u>
Proper increase in net assets for the year ended June 30, 2006	<u>\$29,534,585</u>

The financial statements of the corporation should be a fair presentation of its financial position at June 30, 2006 and the results of its operations and cash flows for the year then ended. Although financial statements were prepared and audited as of and for the year ended June 30, 2006, the financial statements presented were misstated due to this accounting error.

The corporation claims that the \$4 million in appropriations was appropriately excluded from its June 30, 2006 financial statements due to guidance received in Comptroller's Memorandum No. 2005-19, which states that general fund allotments should not be accrued. However, the appropriations in question are not general fund but bond fund allotments. We also confirmed with the Department of Accounting and General Services (DAGS) that the corporation controls the use of the funds and that DAGS serves purely as a payment agent.

Recommendation

We recommend that the corporation's management evaluate the impact of the error noted to the fair presentation of the corporation's consolidated financial statements as of and for the year ended June 30, 2006. We also recommend that fiscal management work with DAGS to ensure appropriate oversight over state appropriations so that such an error does not reoccur and that the corporation's MBP 430 reports include all appropriations that belong to the corporation.

The Corporation's Compensation Structure Is Not Comparable to Other State Agencies

The corporation was established as an instrumentality and agency of the State, and is therefore subject to state laws and regulations unless specifically exempted. Section 323F-8, HRS, allows the corporation to hire a chief executive officer and up to 18 additional employees exempt from the salaries recommended in Section 26-52, HRS. We found that the exempt salaries of corporation executives include retention incentives and severance packages not comparable to other state officials' and may have long-term consequences for the State.

We noted that the base salaries of the corporation's chief executive officer (CEO) and COO/CFO were more than the salaries recommended by the State Executive Salary Commission (Commission). In its *2004 Report of the Executive Salary Commission*, the Commission recommended that compensation for department heads fall within a range of \$93,636 to \$104,040 for FY2006, based on the size of the department. The reason for the higher compensation levels for corporation executives was due to an exemption under Section 323F-8, HRS, which allows the corporation's board of directors to establish the CEO's compensation, and also provides for the CEO to appoint up to 18 other personnel also exempt from the commission's recommended salary ranges.

In his most recent appointment, the corporation's president and CEO was appointed to a seven-year term, January 1, 2005 – December 31, 2011. After December 31, 2011, the CEO's employment automatically renews for three-year terms, unless one of the parties wishes to terminate the agreement. The CEO receives a base salary of \$255,000 per year, and the base salary increases on August 1st of each year by the cost of living increase for the state as determined by the U.S. Department of Labor. The CEO also receives a housing allowance of \$45,000 per year. If the CEO completes the seven-year term, the corporation will pay a retention incentive of one year's current salary plus housing allowance. Additionally, the corporation will pay a retention incentive of one-half year's current annual salary plus one-half year's annual housing allowance after the completion of each three-year term subsequent to the first seven-year term. In the event the CEO is terminated, he will receive a severance package equal to 24 months of his current base salary and housing allowance, exclusive of any incentive payments. The CEO is also a participant in the State's Employees' Retirement System. Salary and years of service are among the factors in the calculation of State retiree benefits.

The corporation's COO/CFO was appointed to a six-year term, August 1, 2005 – July 31, 2011. After July 31, 2011, the COO/CFO's employment automatically renews for three-year terms, unless one of the parties wishes to terminate the agreement. The COO/CFO receives a base salary

of \$217,800 per year. If the COO/CFO completes the six-year term, the corporation will pay a retention incentive of one year's current salary. Additionally, the corporation will pay a retention incentive of one-half year's current annual salary after the completion of each three-year term subsequent to the first six-year term. In the event the COO/CFO is terminated, he will receive a severance package equal to 12 months of his current base salary, exclusive of any incentive payments. The COO/CFO is also a participant in the State's Employees' Retirement System.

The corporation claims that executive compensation is commensurate with the compensation packages of executives at organizations of similar size and stature. In 2004, the corporation's board of directors performed a study on executive compensation among other healthcare organizations in the State, which revealed the following:

Organization	Base Salary (2002)	Total Cash Compensation (2002)
Hawaii Pacific Health	\$575,667	\$725,076
Queen's Medical Center	\$398,160	\$480,629
Castle Medical Center	\$321,711	\$421,518
Rehabilitation Hospital of the Pacific	\$686,371	\$697,965
Kuakini Medical Center	\$218,513	\$230,758

While the corporation's executive total compensation appears to be in line with if not lower than its counterparts in the private sector, it is nearly three times the salary of department heads of other executive agencies. Additionally, state department heads are employed at-will and can be dismissed without any severance benefits, and they do not receive any housing allowances.

Recommendation

We recommend that the HHSC Corporate Board review the compensation packages of its executives. While not bound by state salary schedules, the board should evaluate the aptness of executives' compensation in comparison with other healthcare, insurance, and non-profit organizations, and/or other state agencies, as deemed appropriate. In evaluating executive compensation, the board should consider total compensation and benefits, including the amount or necessity of housing allowances, bonuses, retirement benefits, and severance packages.

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Appendix A

LINDA LINGLE
GOVERNOR

PROCUREMENT POLICY BOARD
DARRYL W. BARDUSCH
LESLIE S. CHINEN
DARYLE ANN HO
GREGORY L. KING
KEITH T. MATSUMOTO
RUSS K. SAITO
PAMELA A. TORRES

AARON S. FUJIOKA
ADMINISTRATOR

STATE OF HAWAII
STATE PROCUREMENT OFFICE
P.O. Box 119
Honolulu, Hawaii 96810-0119
Tel: (808) 587-4700 Fax: (808) 587-4703
www.spo.hawaii.gov

SPO 08-0149

December 28, 2007

MEMORANDUM

TO: Mr. Thomas Driskill, Jr.
President and Chief Executive Officer
Hawaii Health Systems Corporation

FROM: Aaron S. Fujioka, Administrator *Aaron S. Fujioka*

SUBJECT: Applicability of HRS Chapter 103F to the Hawaii Health Systems Corporation (HHSC)

The State Procurement Office (SPO) requested assistance from the Office of the Attorney General (AG) to determine if the Hawaii Health Systems Corporation (HHSC) is subject to the requirements of Hawaii Revised Statutes (HRS) Chapter 103F. We have interpreted that advice as follows:

- (1) When HHSC provides public health and human services, which are directly related to HHSC's regular business activities, through its employees, contractors, and independent medical staff, it is HHSC, the state agency and not a third party provider that is providing the services. In the process of hiring or contracting, if HHSC's human resources office determines that there is an employer-employee relationship, procurement is not applicable as "employees" are a human resource function.
- (2) When HHSC provides health and human services, which are directly related to HHSC's regular business activities, through its contractors and independent medical staff, and HHSC's human resources office determines that an employer-employee relationship doesn't exist, then the services shall be procured under HRS Chapter 103D. In this instance, HHSC is providing the services, not a third party provider.
- (3) When HHSC contracts with a third party provider to provide health and human services, which are not directly related to HHSC's regular business activities, the procurement is subject to HRS Chapter 103F. "Provider" is defined under HRS Chapter 103F-102 as "an organization or individual contracted by a state agency to provide health and human services on its behalf." In this case, HHSC would not be providing the services. As defined, the third party provider would be providing the services on behalf of HHSC.

Mr Thomas Driskill, Jr
December 28, 2007
Page 2 of 2

SPO 08-0149

As a follow-up to Diagnostic Laboratory Services, Inc.'s (DLS) inquiry, laboratory services provided to the public in HHSC's healthcare facilities are directly related to HHSC's regular business activities. Therefore, as long as it is determined that no employer-employee relationship exists, item number (2) above applies.

Thank you for your patience throughout this matter. If you have any questions, please call me at 587-4700.

c: Richard Okazaki, President, Diagnostic Laboratory Services, Inc.
Office of the Ombudsman

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Hawaii Health Systems Corporation, its corporate board of directors, and the Department of Health on March 20, 2008. A copy of the transmittal letter to the corporation is included as Attachment 1. The corporation and its corporate board of directors provided a combined response to our report. This response is included as Attachment 2. The Department of Health did not submit comments to the draft report.

The corporation was extremely critical of our overall engagement approach, and cited the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Attestation Engagements (SSAE) in arguing that the reported material weaknesses in internal control do not comply with industry standards. The corporation also expressed deep concern that inconsistencies between our engagement and the corporation's own external audit results may be due to our lack of conformance with applicable accounting and review standards. The corporation also disputed virtually all of our individual findings. However, the corporation's response demonstrates a lack of understanding of the greater requirements spelled out in auditing standards over governmental entities. Of further concern is the corporation's continued tendency to misconstrue, to its own benefit, laws and official documents applicable to its operations.

The corporation assembles an argument based on AICPA SSAEs to state that we are precluded from providing any opinions on internal controls and we also have no basis to classify any internal control deficiencies as material weaknesses. Although we are precluded from forming an opinion over the corporation's internal controls in accordance with SSAE when performing a financial review, it should be noted that our engagement consisted of a financial statement review *and* an agreed-upon procedures attestation. The material weaknesses identified in our report result from procedures that we performed in connection with the agreed-upon procedures attestation—not the financial statement review.

We also note that Generally Accepted Government Auditing Standards (GAGAS) prescribe additional reporting standards for attestation engagements, which include reviews and agreed-upon procedures, that go beyond the requirements contained in the AICPA SSAEs. Further, Paragraph 6.32, GAGAS, states that, "The report on an attestation engagement should disclose deficiencies in internal control, including internal control over compliance with laws, regulations, and provisions

of contracts or grant agreements that are material to the subject matter or assertion.” The definition of materiality was agreed to by the “specified parties”—Accuity and the State Auditor. The determination of material weaknesses and reportable conditions are a matter of professional judgment. All audits and other engagements conducted by the Office of the Auditor and its contractors comply with GAGAS, and this engagement is no exception.

During the course of our engagement we found that the corporation had a tendency to make unilateral determinations regarding its exemption from various parts of state procurement laws. Upon review of the various documents provided by the corporation to support its claims, it is clear that the corporation’s conclusions are based on either a misinterpretation or misrepresentation of the content of those documents. The corporation’s response disputes most of our procurement related findings based on a January 2005 letter from the State Procurement Office (SPO) that delegates the procurement authority of the Chief Procurement Officer (CPO) to the corporation. The corporation interprets this authority to mean it is able to develop procurement procedures that are contrary to state procurement laws, and cites this authority as justification for raising its small purchase threshold, from the \$25,000 level established in state law, to \$100,000.

Based on the SPO’s delegation, which the corporation incorrectly refers to as an “exemption,” the corporation notes that it immediately established a policy to exempt its purchase of goods, services, and construction that were less than or equal to \$100,000 from competitive IFB (invitation for bids), RFP (request for proposals), or professional services listing. This is an abuse of the SPO’s delegation and in violation of state procurement laws. The CPO may delegate any authority but is still bound to comply with state laws and rules governing procurement. The CPO or its designee may also grant procurement exemptions; however, Section 3-120-5, Hawai‘i Administrative Rules, states that a “Request for Exemption from Chapter 103D, HRS”, must be completed *and* that in determining whether to approve the exemption, the CPO shall consider the circumstances of each individual case. As such, the corporation is prohibited from establishing a blanket exemption policy.

Our engagement assessed the corporation’s compliance with state procurement laws, use of lease financing arrangements, management of its informational systems, accounting and safeguarding of its customer billings, and monitoring and management of conflicts of interest. We stand by the conclusions in our report.

More specific responses to the corporation’s comments can be found on the following pages.

Responses to the Hawaii Health Systems Corporation's Specific Comments Relating to Our Findings/Recommendations:

#1 Corporation comment: *The corporation developed model policies in compliance with the procurement code. The recent review by Accuity and the Office of the Auditor did not take into account consideration of delegation of procurement authority granted to HHSC on January 20, 2005, which lead to inaccurate comments and findings in the draft audit report.*

Auditor's response: **The chief procurement officer (CPO) with jurisdiction over HHSC at the time of our review was the administrator of the State Procurement Office (SPO). Chief procurement officers have broad procurement authority over their respective jurisdictions and are allowed by state law to delegate any of those authorities. However, any procedures developed and implemented by the CPO's and their delegates in exercising their authority must still comply with state procurement laws.**

Although the SPO letter dated January 20, 2005, delegated procurement authority to the CEO of HHSC, it did not give the CEO the authority to develop procurement policies contrary to the state procurement code. However, the corporation's response states it raised its small purchase threshold from \$25,000 to \$100,000, exempting purchases of less than this threshold from the more stringent competitive purchase requirements—a clear violation of the procurement code. We also question the timing of this justification since the corporation's policy to raise the threshold was issued by its CFO and approved by its CEO in September 2003 (nearly a year and a half prior to the SPO's delegation of authority). We further question why this letter was not provided to us during our engagement or even after our exit conference to discuss the findings.

We confirmed with the SPO administrator that the aforementioned letter merely gives the HHSC CEO the authority to implement the statutory requirements of Chapter 103D, HRS, which primarily consists of ensuring the corporation's compliance with the provisions of the state procurement code. The administrator also explicitly stated that the CEO of HHSC was not delegated the authority to approve procurement violations.

#2 Corporation comment: *The corporation did not unilaterally exempt itself from the requirement of Chapter 103F, HRS.*

Auditor's response: **Although none of the exceptions we noted were in violation of Chapter 103F, HRS, we reemphasize the fact that if the corporation contracts with a third party to provide health and human services on behalf of the corporation, and the services are not related to the corporation's regular business activities, those transactions would be subject to Chapter 103F, HRS. Our finding focuses on management's repeated claims that the corporation is exempt from the requirements of Chapter 103F, HRS.**

#3 Corporation comment: *The corporation's procurement policies do not violate the procurement code in regards to "small purchases order". Due to the exemption granted to HHSC on January 20, 2005, the Independent Chief Procurement Officer approved an immediate procurement exemption via an MFR, with formal request for exemption signed on April 6, 2005 to exempt the purchases of goods, services, and construction that were less than or equal to \$100,000 from competitive IFB, RFP, or professional services listing.*

Auditor's response: **As previously stated, the SPO administrator can delegate any of its authority as CPO, but that authority must always be exercised within the constraints of the state procurement code. The corporation abused its delegated authority in defining small purchases as being \$100,000 or less, contrary to state laws that define small purchases as those less than \$25,000. We fail to see how the SPO delegation of authority letter exempts the corporation from any section of the state procurement code.**

#4 Corporation comment: *The corporation carefully and appropriately managed transitional contracts.*

Auditor's response: **We do not dispute the fact that the state procurement code was not in effect for contracts executed prior to January 1, 2005. However, all exceptions that were identified in our report represent contracts that were legally executed subsequent to January 1, 2005, specifically during fiscal year 2006.**

#5 Corporation comment: *The decentralization of HHSC, in general, will continue to occur as we implement Act 290.*

Auditor's response: **We do not dispute the fact that a decentralized process is more time consuming and tedious. However, nowhere in our report did we make the claim that allowing hospitals to do some of their own procurement was inappropriate. We simply stated that the decentralized procurement process and the lack of a centralized contracts management system made it difficult for the corporate procurement manager to adequately monitor procurement activities across the entire system.**

#6 Corporation comment: *The corporation disputes the following procurement findings noted in the draft audit report.*

Auditor's response: **As previously stated, the letter issued by the SPO on January 20, 2005, did not give the CEO of HHSC the authority to modify the corporation's procurement policies despite their conflicting with the state procurement code. Also, all exceptions that were identified in our report represent contracts that were legally executed subsequent to January 1, 2005, specifically during fiscal year 2006. Lastly, we noted during our fieldwork the two contracts that are in violation of Section 103D-314, HRS, were not fixed-price contracts, but rather contracts that required the corporation to pay the vendor based on a formula as stated in the contract.**

#7 Corporation comment: *The corporation's use of lease financing is just plain good business sense.*

Auditor's response: **The corporation's response does not address the claim that the State may be held contingently liable in the event the corporation defaults on its lease payments, nor does it address the fact that the corporation does not comply with the state procurement code when procuring equipment through this type of lease financing transaction. The corporation's response emphasizes the fact that it is using municipal lease financing to circumvent the state procurement code: "Equipment purchases that are leased through municipal financing were included on the 10-year CIP plan as critical and safety purchases, but were not funded by the State. Therefore, management was forced to find alternative means to fund these purchases. . ."**

#8 Corporation comment: *The corporation manages capital assets without imposing the expense of a system-wide uniform capital asset tracking system.*

Auditor's response: **A uniform capital asset tracking system across the corporation will promote greater understanding of the capital asset tracking process and reduce the likelihood of errors, including those stemming from the use of manual spreadsheets.**

It is also difficult to believe that all facilities conducted an annual physical inventory as of June 30, 2006, when the fiscal officers at the various facilities were unable to locate the exceptions we noted. Thus, if an annual inventory was performed, it is quite clear that it was not performed effectively since the fiscal officers at the various facilities were unable to locate all of the items we selected for testing. We also are unsure as to what other procedures we needed to perform to verify the existence of the assets besides asking the various fiscal officers to show us where the assets were located. If the fiscal officers were unsure, they could have directed us to meet and discuss the issue with a more appropriate person. Also, most of the assets that management was unable to locate appear to be of considerable size; and thus, we are confused as to how management would be unable to locate these assets that are on its facilities' books and purportedly, in its facilities' control.

#9 Corporation comment: *The corporation adequately established information technology security policies and procedures to manage and minimize risk of exposure of its sensitive information, third party access to systems and applications, and monitoring activity.*

Auditor's response: **"Weekly review of access reports and logs" – While the corporation states that this control is performed, it also states that the process has not yet been formalized, which for all intents and purposes means that the control is not being performed and was not performed during the period under review.**

"Vendor ID and passwords" - The performance of this control is dependent on the corporation's ability to review the access reports and logs mentioned above, which management already stated "has not yet been formalized" and was not performed during the period under review.

"Financial reports prepared from Series" – While this control would allow management to detect potential misstatements in the data that's posted to the Series system, this control was not implemented during our fieldwork, and thus is irrelevant for the purposes of our review.

"Onsite HHSC IT staff" – This is not a control activity since there is no mention of how the IT staff would prevent or detect a material misstatement of the corporation's financial statements. Even with an IT staff that's available 24-hours a day, 7-days a week, they would have no way to monitor the vendor's access to the Series system since the corporation does not perform a review of its access reports and logs.

"Upgrades and other major changes" – This control does not mitigate the risk of unauthorized activity by a third-party vendor, since the vendor would be able to bypass this control activity due to its access abilities. Upgrades and major changes are also planned activities that the corporation's management would be aware of. However, unauthorized access by vendors could occur without management's knowledge without the proper user access controls in place.

"Vendor is granted appropriate access" – This control is irrelevant since the corporation provided unrestricted and unmonitored access to its third-party vendors during the period of our review. Regardless of the terms of the contract or how thorough a background check is performed, management will not gain adequate assurance over its vendor access to the corporation's systems until it monitors the changes and activities of its vendors.

#10 Corporation comment: *The corporation recognizes the need to control user access and terminated user reviews and acts accordingly. As noted in the key controls listed above in comment #8, management believes that the weekly review of access reports and logs mitigates the risk identified in the draft audit report and allows for timely notification of unauthorized users and/or inappropriate access.*

Auditor's response: **The key controls listed in the previous response are specifically meant to monitor direct access to systems and data by the third-party vendor. They are neither a user access review nor a terminated user review, since they do not address the risk of the corporation's end users having access rights to sensitive systems that are commensurate with an employee's job responsibilities, nor do they address the risk of terminated employees accessing the corporation's systems.**

#11 Corporation comment: *The corporation accurately calculates contract adjustments, bad debts, and estimated values of accounts receivables in accordance with GAAP. As stated in Chapter 5 of the AICPA Audit and Accounting Guide for Health Care Organizations section 5.03, "Revenue and the related receivables for health care services usually are recorded in the accounting records on an accrual basis at the provider's full established rates" (this would mean gross revenue).*

Auditor's response: **The corporation's response conveniently omits the second sentence of the cited paragraph from the AICPA Audit and Accounting Guide for Health Care Organizations, which states that, "the provision for contractual adjustments (that is, the difference between established rates and third-party payor payments) and discounts (that is, the difference between established rates and the amount collectible) are recognized on an accrual basis and deducted from gross service revenue to determine net service revenue". For the corporation to recognize the gross service revenues, and not offset it with the estimated contractual adjustments during the same period, would contradict the matching principle of generally accepted accounting principles, which requires that expense recognition to be tied with revenue recognition. And while the State Auditor did state in its April 2002 report that the corporation's overall methodology for calculating contractual adjustments (reserves) and bad debt is technically accurate, we do not dispute the corporation's methodology for calculating its allowance for contractual adjustments (reserves) and bad debt – we do however, disagree that the timing for when the allowance for contractual adjustments are recognized is not consistent with generally accepted accounting principles.**

Also, the corporation's response included the following guidance from the AICPA Audit and Accounting Guide for Health Care Organizations, "Estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles are reported in the period during which the services are provided even though the actual amounts may become known at a later date". Thus, we fail to see the basis for management's argument since management candidly pointed out the accounting guidance that completely contradicts its accounting policy.

#12 Corporation comment: *The corporation continuously monitors incidence of untimely submission of patient claims to improve performance. The amount of lost revenue noted at our three rural facilities, represents approximately .04% of the total patient service revenue and less than .001% of the total patient service revenue for all of HHSC for the year ended June 30, 2006.*

Auditor's response: **While the amount of lost revenue was less than 1% of total patient service revenues, it represented approximately 4 percent of the sample we selected for testing. Thus, if we were to project this misstatement percentage to the corporation's entire gross receivable balance as of June 30, 2006, the amount of lost revenue would be approximately \$7 million.**

#13 Corporation comment: *The corporation records cash receipts/contractual adjustments in a timely manner.*

Auditor's response: **While the corporation contends that its policies and procedures ensure that cash received and contractual adjustments are posted to the billing system in a timely manner, we are merely presenting the findings from the procedures we performed. Also, we did not consider this stand-alone finding to be a material weakness. Rather, it was just one of the deficiencies in the corporation's internal control over the revenues and receivables process that when aggregated, amounted to a material weakness.**

#14 Corporation comment: *The corporation records payment for long-term care patients appropriately. HHSC implemented a policy in which all credit balances are reviewed on a monthly basis via a report issued by the Corporate revenue department. Subsequent to the audit, credit balances are researched and resolved in a timely manner.*

Auditor's response: **The corporation's response fails to state when the policy was implemented. However, during our review, it was clear that the policy was not being effectively executed since credit balances as of June 30, 2006 were still unresolved during our fieldwork, which was performed in February 2007 (8 months after year-end).**

#15 Corporation comment: *The delays in the review and agreed-upon procedures engagement were due to the following: ineffective and inefficient communication amongst all parties (no face to face meeting, except on January 24, 2008); lack of industry knowledge on the part of Accuity; unreasonable demands made by Accuity and the Office of the Auditor regarding the signing of the management representation letter; and decentralized processes.*

Auditor's response: **We conducted several face-to-face meetings with members of management including the following: entry conference on July 21, 2006, meeting with the corporate controller on December 4, 2006, and various meetings with the fiscal officers at the various facilities. We also found it very difficult to plan discussions with members of corporate management when it was clear how unresponsive they were to our questions and requests, which is evidenced by the fact that we were unable to commence our review and agreed-upon procedures engagement until December 2006, approximately four months after the engagement was initially scheduled to begin.**

We also find it interesting that the corporation would question Accuity's industry knowledge when it was one of the firms that HHSC deemed to have met the minimum qualifications to serve as the corporation's external auditors. And although the corporation is a decentralized organization, we noted that the corporation was able to accommodate Deloitte & Touche, LLP, to complete its audit of the corporation within six months after year-end. Thus, we do not see why it would be any more difficult for management to gather the necessary information in order for us to complete our financial statement review, which is substantially less in scope than an audit. Therefore, neither Accuity nor the Office of the Auditor accepts any responsibility for the delays incurred.

#16 Corporation comment: *Corporation provided representation as to the accuracy of financial statements to Deloitte & Touche but could not provide representation to Accuity on its financial review and undisclosed reporting. Accuity did not conduct an audit of HHSC's financial statements but yet requested that HHSC management provide the same representations made to Deloitte & Touche for the years ended June 30, 2006, and June 30, 2005. We consider this request to be unprofessional.*

Auditor's response: **Management claims that it was not allowed to review the draft of the financial statements prior to signing the management representation letter, when in fact it was provided with a draft of the financial statements on November 16, 2007. Management suggested that several changes be made to the financial statements; the changes were made, and a revised draft of the financial statements was sent to management (COO/CFO and corporate controller) for review on November 30, 2007. Thus, management clearly had the opportunity to review a draft of the financial statements.**

Also, management continues to use the excuse that it was not able to review other reports issued by Accuity or the Office of the Auditor. However, we made it clear to management several times that the management representation letter pertained only to the corporation's financial statements. The representations requested in the letter were consistent with American Institute of Certified Public Accountants Attestation Standards and Generally Accepted Government Auditing Standards for financial statement review engagements.

#17 Corporation comment: *The corporation's financial statements correctly reported bond fund appropriations for fiscal years ending June 30, 2006 and June 30, 2007. ...Regarding time requirements, DAGS would only provide capital asset resources for the fiscal year that is covered by the appropriation, limited to the amounts that would be expended in that year. Further, paragraph 64 of GASB 33 states, "The Board concluded that the conceptually appropriate recognition point for assets and liabilities in nonexchange transactions is when an enforceable legal claim to resources arises, based on the specifications of enabling legislation or contractual requirements. However, the Board also concluded that if a claim to assets is not realizable (for example, enforcement of the claim is not probable), the transaction should not be recorded." In HHSC's case, it could not enforce a claim against the State for the unexpended appropriations that lapse at the end of the year.*

Auditor's response: **Based on our review of the Department of Health MBP 430 report as of June 30, 2006, the funds in question were appropriated and allotted in FY2006, which means the funding was enabled through legislation and released by the governor. Additionally, it should be noted that the appropriations in question did not lapse at the end of FY2006, as evidenced by expenditures of these funds during the subsequent year (FY2007). Further, CIP funds for the State do not usually lapse after one fiscal year—funds are usually available for expenditure for two to three years before lapsing.**

#18 Corporation comment: *The corporation's executive total compensation is significantly less than executive compensation in the private sector and similar to others in government.*

Auditor's response: **Although the corporate executives' total compensation is less than that of their private sector counterparts, we still emphasize the fact that the corporation is an agency of the State of Hawai'i, and thus, compensation is typically less than executives in the private sector. We also noted that the compensation levels of the heads of the vast majority of other departments and agencies of the State of Hawai'i are significantly less than the corporation's CEO and COO/CFO. The corporation's response also did not address the compensation of the CFO/COO and the severance packages that these employees will receive.**

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



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

March 20, 2008

COPY

Mr. Thomas M. Driskill, Jr.
President and Chief Executive Officer
Hawaii Health Systems Corporation
3675 Kilauea Avenue
Honolulu, Hawaii'i 96816

Dear Mr. Driskill:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial Review of the Hawaii Health Systems Corporation*. We ask that you telephone us by Monday, March 24, 2008, 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 2:00 p.m. on Friday, March 28, 2008.

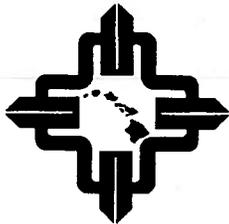
The Hawaii Health Systems Corporation Board of Directors, Department of Health, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

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 Every Day"

April 4, 2008

CEO-08-027a..

RECEIVED

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

2008 APR -4 AM 11:39

OFFICE OF THE AUDITOR
 STATE OF HAWAII

Dear Ms. Higa:

Thank you for the opportunity to respond to the draft audit report of the Hawaii Health Systems Corporation (HHSC) for the fiscal year ended June 30, 2006. On behalf of the HHSC Board of Directors and management, we are providing comments on the audit process and audit standards and on the findings/recommendations to the draft report. The attached appendix addresses the findings/recommendations contained in your report, while this cover letter is intended to focus on our concerns over basic auditing and protocol standards used by Accuity LLP and to discuss policy changes/improvements we have made as a result of implementation of Act 290.

The Office of the Legislative Auditor engaged Accuity LLP to perform a financial review of HHSC's financial statements for the year ending June 30, 2006. This financial review followed a thorough financial audit for the same period conducted by the Certified Public Accounting firm of Deloitte & Touche (D&T). An unqualified opinion was issued by D&T and no "material weaknesses" were noted.

As will be discussed in the attached Appendix Section, a number of "material weaknesses" were noted in the draft audit report of Accuity LLP. Based upon the American Institute of Certified Public Accountants Statement on Standards for Attestation Engagements (SSAE), section 201, we believe that Accuity's use of the term "material weakness" to describe their findings is inconsistent with industry standards.

The Board of Directors of HHSC took action at its meeting of March 13, 2008 which adopted Sarbanes/Oxley (SOX) guidelines over the annual external audit. The Finance, Information Systems and Audit Committee of the Board of Directors was assigned and authorized to hereinafter oversee the annual audits and review all audit findings/recommendations that result. An amendment to our By Laws was approved to memorialize this action. This action was taken by the Board to affirm their commitment

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that financial records will be kept in accordance with generally accepted accounting standards and that HHSC business shall be conducted in accordance with all applicable laws of this state and country.

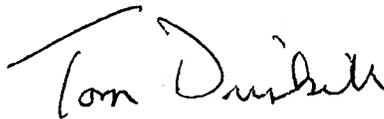
Additionally, the Board has adopted a draft interim plan to assist and facilitate the implementation of Act 290. With this overall interim plan in action, each of the five Regional Boards has been called into action to develop and adopt their respective Regional Strategic Plan. Each region shall be responsible for determining its level of service and develop an action plan to assure the long-term viability of hospital services. While we do not anticipate any immediate break-even scenarios as a result, we do expect some "out of the box" creativity to slow the downward spiral we are currently experiencing.

Thank you again for allowing us to respond to the draft audit report. Specific responses to the report can be found in the attached appendix.

Sincerely,



Andrew Don, M.D.
Chair
Hawaii Health Systems Corporation



Thomas M Driskill, Jr.
President & CEO
Hawaii Health Systems Corporation

Enclosures: Appendix

APPENDIX to HHSC April 4, 2008 Response and Corrections to Draft Legislative Audit
Report Provided by Legislative Auditor Prior to Issuance

AUDIT STANDARDS:

Based on the scope and methodology noted on page 5 of the draft audit report, we understand that your office contracted with Accuity LLP to perform a review, which is substantially less in scope than an audit, of the consolidated financial statements of HHSC and perform certain agreed-upon procedures in accordance with AICPA Statement on Standards for Attestation Engagements (SSAE).

According to the AICPA SSAE section 201, "Agreed Upon Procedures Engagements", we believe the use of Accuity's term "material weakness" to describe their findings are inconsistent with industry standards based on the following AICPA guidance:

1. Section AT201.31(k) – states that one of the required elements of an agreed-upon procedures report is, "a statement that the practitioner was not engaged to and did not conduct an examination of the subject matter, the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter, and a statement that if the practitioner had performed other procedures, other matters might have come to his or her attention that would have been report."

In basic terminology, this guidance precludes Accuity from expressing an opinion on either HHSC's financial statements or internal controls.

2. Section AT201.03 – states, "In an engagement performed under this section, the practitioner does not perform an examination or a review, as discussed in section 101, and **does not provide an opinion** or negative assurance.

By defining several of their findings as "material weaknesses", Accuity is expressing an opinion over HHSC's internal controls, and is precluded from doing so as noted by Section AT201.03.

3. Section AT201.25 – states, "The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report."

We do not find that the draft audit report contains any reference to agreed-upon materiality limits, and further, if no such limits were ever agreed-upon, then Accuity has no basis to conclude that any of the deficiencies are material weaknesses.

Therefore, based on the comments noted above, HHSC Board members and management, dispute all claims of material weaknesses reported in the draft audit report and request that the report be amended to adhere to guidelines established by the AICPA.

AUDIT PROCESS:

We understand that you recently met with our external auditors, Deloitte & Touche, who reviewed and discussed with you the draft audit report. After coordinating with your office, Deloitte & Touche concluded that it is **NOT** necessary to restate the consolidated financial statements for the years ending June 30, 2006 and June 30, 2005 and will subsequently be issuing an unqualified opinion for the comparative financial statements for the years ending June 30, 2007 and June 30, 2006.

Deloitte and Touche also confirmed that based on their audit work performed for the years ending June 30, 2007 and June 30, 2006, HHSC did not have any material misstatements in the financial statements, nor were there any reports of a material weakness as defined by the AICPA Statement on Auditing Standards 112.

Being that Accuity LLP performed a review and not an audit, HHSC Board members and management are perplexed at the despairing results between Accuity LLP and Deloitte & Touche. Management is deeply concerned that the inconsistent results may be due to Accuity's lack of conformance with accounting and review standards generally accepted in the United States of America and the standards applicable to financial reviews contained in the *Governmental Auditing Standards*, issued by the Comptroller General of the United States. We encourage that the inconsistent results be resolved amongst all parties before the final audit report is issued.

FINDINGS/RECOMMENDATIONS:

In following paragraphs, we will highlight issues that have not been accurately reported in the draft audit report. HHSC Board members and management request that the draft audit report be revised accordingly before final issuance.

1. The Corporation's Developed Model Policies in Compliance With The Procurement Code (see page 8 of the Draft Audit Report).

HHSC Board members and management do not dispute that HHSC was subject to the provisions of the State procurement code 103D during the period under review and as well as today. However, as evidenced by a letter dated January 20, 2005, from the SPO, confirming the delegation of procurement authority for Chapter 103D, HRS to the HHSC Chief Executive Officer, HHSC had the authority and approval to act as an Independent Chief Procurement Officer (ICPO). This delegation was effective January 20, 2005 until July 1, 2007 when the State procurement code for HHSC was revised by Act 290.

The recent review by Accuity and the Office of the Auditor did not take into consideration the delegation of procurement authority granted to HHSC on January 20, 2005, which lead to inaccurate comments and findings in the draft audit report (see detail under comment #5). Specifically, this letter granted authority to the ICPO with delegation for all threshold levels for goods, services, and construction for:

1. Procurement exempt form Chapter 103D, HRS (Chapter 3-120, HAR)
2. Preparation of Specifications (Section 3-122-11, HAR)
3. Procurement Protest (Section 103D-701, HRS)
4. Contract Controversies (Section 103D-703, HRS)
5. Source Selection Methods (Chapter 3-122, HAR):
 - Competitive Sealed Bids (Subchapter 5)
 - Competitive Sealed Proposals (Subchapter 6)
 - Small Purchase (Subchapter 8)
 - Sole Source (Subchapter 9)
 - Emergency (Subchapter 10)
6. Section 3-130-12 HAR, on Exceptions for Inventory Management
7. Section 3-122-13, HAR, on Development of Specifications
8. Sections 3-122-223 and 3-122-224, HAR, on Bid Deposits and Contract Security
9. Section 3-124-26, HAR, Mandatory purchase of office paper and printed material with recycled content

Management Status Update:

Since implementing the State's procurement code on January 1, 2005, management has devoted much time and resources to ensure full compliance. This is evidenced by the hiring of contract managers at each of the Regions within HHSC, as well as a Director of Procurement to oversee the entire internal procurement process. Each contract manager is an affiliated member of the National Association of Government Procurement. In addition, all of our contract managers have attended SPO training sessions. Finally, as matters arise that require legal interpretation and understanding of the procurement code, HHSC management has not hesitated to seek assistance from the SPO and internal/external legal counsel and under no circumstances have we disregarded any interpretations or recommendations made to us.

2. The Corporation did not unilaterally exempt itself from the requirement of Chapter 103F, HRS (see page 10 of the Draft Audit Report).

As stated in the draft audit report on page 12, HHSC is subject to Chapter 103F HRS if the Corporation contracts with a third party provider to provide health or human services on behalf of the corporation, and the services are not related to the corporation's regular business activities. During the period under review and all periods prior to and subsequent to, HHSC did not enter into any contracts that

were not related to the corporation's regular business activities. As such, the provisions of Chapter 103F are simply not applicable to HHSC contracts. Furthermore, the draft audit report cites no contracts entered into by HHSC in violation of Chapter 103F, obviating the need for further comment.

3. The Corporation's procurement policies do not violate the procurement code in regards to "small purchase order" (see page 12 of the Draft Audit Report).

HHSC Board members and management agree that the definition of a small purchase order as noted in Section 103D-305, HRS, are purchases for goods, services, or construction that are less than \$25,000. However, there seems to be a misunderstanding of which rules of the procurement code apply to the test selections. Due to the exemption granted to HHSC on January 20, 2005 (as noted above in comment #1), the ICPO approved an immediate procurement exemption (as stipulated under section 103D-102 (b) (4) L and HAR section 3-120) via an MFR, with formal request for exemption signed on April 6, 2005 to exempt the purchases of goods, services, and construction that were less than or equal to \$100,000 from competitive IFB, RFP, or professional services listing. Competition was still required, although the formal process of a request for proposal or invitation for bid was optional up to \$100,000. The process required a minimum of three quotes and imposed other procurement code requirements where applicable, such as tax clearance certificates and other compliance documents. Sole source and emergency procurement procedures were still required where appropriate. Therefore, HHSC Board members and management believe that our internal policies do not violate the State Procurement Code.

4. The Corporation carefully and appropriately managed transitional contracts (see page 13 of the Draft Audit Report).

Allegations that HHSC violated provisions of the procurement code by giving effect to existing contract provisions are without merit. At the time the procurement code became applicable to HHSC on January 1, 2005, hundreds of contracts were in existence and dozens were in various stages of development. In order to implement a smooth transition for pre-existing contracts, HHSC management consulted with legal counsel and the SPO. It was determined that the 103D procurement code was not in effect for pre-existing contracts (contract entered into prior to January 1, 2005) and it was further determined that it was not reasonable to terminate procurement actions already in process prior to January 1, 2005. These contracts were to be processed under the former HHSC policies and procedures.

5. The decentralization of HHSC, in general, will continue to occur as we implement Act 290 (see page 13 of the Draft Audit Report).

HHSC Board members and management realize that reviewing a decentralized process is more time consuming and tedious. However, we disagree with the assertion that allowing hospitals to do some of their own procurement was inappropriate. In order to meet the demands of the high-paced health care operation and to offset the challenges of being physically separated from most of our facilities, it was imperative that on-site contract managers were there to assist in the procurement process. It took time to recruit and train sufficient personnel to carry the huge additional workload required by the implementation of the procurement code in 2005 and we continue to monitor and evaluate our processes to ensure full compliance.

Management Status Update:

It should be noted that in accordance with Act 290, which act has created Regional System Boards and mandated further autonomy for the regions, it is particularly appropriate to empower regions and hospitals to manage their own procurement. The legislature recognized the negative impact of the procurement code on timely appropriate procurement of goods and services for hospitals by exempting the HHSC Regional System Boards from chapter 103D, HRS once appropriate procurement policies have been established in each region.

6. The Corporation disputes the following procurement findings noted in the draft audit report (see page 13-16 of the Draft Audit Report).

Based on the authority granted to HHSC by letter date January 20, 2005 and the fact that pre-existing contracts prior to January 1, 2005 follow previous HHSC policy and procedures, the following selections noted on page 14 - 16 of the draft audit report are not in violation of the code and should therefore be removed and the report revised accordingly:

Sel #	Contract #	Vendor Name	Amount	Reason for Discrepancy
1	06-328	Clinical Labs	\$150,000	Pre-existing contract – not applicable to 103D
2	06-162	Fresenius	\$100,000	Procurement Exemption from SPO letter dated January 20, 2005
3	06-617	Goodman & Associates	\$99,750	Procurement Exemption from SPO letter dated January 20, 2005
4	06-164	KONE	\$75,000	Procurement Exemption from SPO letter dated January 20, 2005
5	06-242	Automated Technologies	\$159,582	Procurement Exemption from SPO letter dated January 20, 2005
6	05-073	Powell Goldstein, LLP	\$450,000	Pre-existing contract – not applicable to 103D
7	03-004	Otis Elevator Co.	\$889,891	Pre-existing contract – not applicable to 103D

The two selections noted below are classified as firm fixed-price contracts. In accordance with Section 103D-314, HRS, firm fixed-price contracts are exempt from this requirement and therefore, it was not necessary for the ICPO or any other designee to obtain a written determination that the proposed contractors' accounting systems would permit timely development of all necessary cost data in the form required by the specific contract type contemplated and that the proposed contractor's accounting system was adequate to allocate costs in accordance with generally accepted accounting principles.

Sel #	Contract #	Vendor Name	Contract Amount	Reason for Discrepancy
1	06-138	Managed Resources	\$500,000	Not applicable as contract is fixed-price
2	06-272	Pacific Medicaid Services, Inc.	\$300,000	Not applicable as contract is fixed-price

7. The Corporation's use of lease financing is just plain good business sense (see page 16 of the Draft Audit Report).

HHSC Board members and management agree that municipal leasing may not be the most conservative means to purchase equipment. However, it makes good business sense when HHSC is faced with the decision to find additional funding to purchase much-needed patient safety equipment to provide the quality care that is expected and deserving in the communities that we serve. Equipment purchases that are leased through municipal financing were included on the 10-year CIP plan as critical and safety purchases, but were not funded by the State. Therefore, management was forced to find alternative means to fund these purchases in order to uphold our commitment to providing quality care.

The corporation utilizes municipal lease financing in accordance with its legislated authority. Alternatives to municipal leasing include operating leases, commercial loans, or the issuance of revenue bonds or general obligation bonds. In the case of operating leases and commercial loans, both have higher interest rates than our municipal lease financing and therefore would be less cost-effective to the corporation. In the case of issuing bonds, this option would be inappropriate because of the small dollar value of the lease amounts as compared to bond issuance amounts, and the need for timely action.

Management Status Update:

It should be noted that the corporation has always made timely payments on all debt and municipal lease scheduled payments and provides full access of information on all municipal lease programs to the Department of Budget & Finance as well as applicable legislative committees.

8. The Corporation manages capital assets without imposing the expense of a system-wide uniform capital asset tracking system (see page 18 of the Draft Audit Report).

Although HHSC does not have a uniform capital asset tracking system, we do have procedures and controls in place that mitigate the risk of properly safeguarding our assets. The following procedures and controls were in place during the period under review:

- Fixed assets are manually tracked in an Excel spreadsheet, with the description of the asset, vendor name, purchase date, purchase price, and location. Further noted that all hospital equipment is separately tracked by the biomedical department in conjunction with JHCOH requirements relating to preventative maintenance. The biomedical fixed asset detail is reconciled to the general ledger, at minimum, on an annual basis.
- All HHSC facilities conducted an annual physical inventory of fixed assets as of June 30, 2006.

The assets listed in the draft audit report on page 19 were all in existence and in use as of June 30, 2006. HHSC management believes that there may have been an issue with location, and that Accuity did not perform the necessary additional procedure to conclude proper existence. As such, management disputes that the financial statements for the year ended June 30, 2006 were overstated by approximately \$1.1 million.

Furthermore, the total net book value of all capital asset was \$221,454,648 as of June 30, 2006. Of that amount \$188,524,053, represented land, building, improvements, which are considered to be easily identified if no longer in existence. The remaining \$32,930,595 represented fixed equipment, which would be more susceptible to misappropriation. This represents about 10% of the total assets for HHSC as of June 30, 2006. As such, management will consider the need to purchase a uniform capital asset tracking system based on the cost-benefit analysis to purchase such a system, as well as considering the competitive need for other purchases necessary to continue to serve our patients and provide quality care.

Management Status Update:

In accordance with Act 290, custodial control of assets will be being transferred to Regional System Boards. Recommendation for implementation of formal capital asset tracking policy will be forwarded to Regional System Boards for consideration.

9. The Corporation adequately established information technology security policies and procedures to manage and minimize risk of exposure of its sensitive information, third party access to systems and applications, and monitoring activity (see page 21-23 of the Draft Audit Report).

The Corporation has implemented several key controls that help mitigate the risk of unauthorized access and inadequate monitoring for all of HHSC information technology systems. In addition to the key controls listed below, management has also hired a full time, certified information system security professional (CISSP) to continue the effective monitoring and managing of risk.

Key IT Controls:

- IT management performs a weekly review of access reports and logs, which monitors ALL activity executed by the vendor as well as in-house IT. This process has not yet been formalized and management is considering your recommendation.
- Each vendor has its own, separate and unique ID and password, which enables HHSC IT to monitor the activity reports noted above. HHSC requires each vendor to change his or her password every 90 days.
- Financial reports prepared from Series such as A/R, Revenue, and Census Information are distributed to the Regions on a daily basis. The regions perform daily reconciliations of the Census information, and monthly reconciliations of the A/R and Revenue information captured in Series. As such, possible significant material misstatement reflected in the data captured in Series would be detected and resolved in a timely manner.
- An on-site HHSC IT staff is available 24-hours a day, 7-days a week
- Upgrades and other major changes to the system are validated for integrity (as evidenced by package reports submitted to Corporate IT) and certified by each facility's CFO or designated person stating that upgrade was implemented successfully and that testing is complete.
- Each vendor is granted the appropriate access based on contract terms in accordance with approved policy and procedures. Rigorous vendor background checks are performed regularly in accordance with the State's Procurement Code.

10. The Corporation recognizes the need to control user access and terminated user reviews and acts accordingly (see page 21 of the Draft Audit Report).

As noted in the key controls listed above in comment #8, management believes that the weekly review of access reports and logs mitigates the risk identified in the draft audit report and allows for a timely notification of unauthorized users and/or inappropriate access. Our current weekly reviews are more frequent than what was recommended in the report, which was at minimum, a semi-annual review of user accounts and a quarterly review of terminated user access.

11. The Corporation accurately calculates contract adjustments, bad debts, and estimated values of accounts receivable in accordance with GAAP (see page 24 of the Draft Audit Report).

As stated in chapter 5 of the AICPA Audit and Accounting guide for Health Care Organizations section 5.03, "Revenue and the related receivables for health care services usually are recorded in the accounting records on an accrual basis **at the provider's full established rates**" (this would mean gross revenue). It further states, "Contractual adjustments, discounts, and an allowance for uncollectibles are recorded to report the receivables for health care services at net realizable value. Estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles are reported in the period during which the services are provided even though the actual amounts may become known at a later date. This later date may be (a) when the person is discharged, (b) subsequent to discharge or completion of service, (c) when the third party is billed, or (d) when payment or partial payment is received."

Further, in April 2002, your office issued a "Follow-Up Study of the Hawaii Health Systems Corporation", which on page 53 you referred to the work of your healthcare consultant regarding our accounting for revenues and receivables as follows: "Our consultants found that the corporation's overall methodology for calculating contractual adjustments (reserves) and bad debt is technically accurate and leads to a reasonable estimate of the value of accounts receivable."

Based on the AICPA guidance, the Office of the Auditor's Follow-Up Study, and the understanding that Deloitte & Touche performs our annual audit in accordance generally accepted accounting principles (GAAP), HHSC Board members and management are confident that the corporation's revenues, receivables, contractual allowances and adjustments, and bad debts are properly being recorded in the financial statements.

12. The Corporation continuously monitors incidence of untimely submission of patient claims to improve performance (see page 27 of the Draft Audit Report).

Due to the complexities and significant manual operations within the billing cycle, management has implemented adequate controls to minimize the risk of the untimely billing of patient claims. This risk cannot be eliminated and therefore management accepts a minimal percentage of claims that will not be submitted timely. The amount of lost revenue noted at our three rural facilities, represents approximately .04% of the total patient service revenue and less than .001% of the total patient service revenue for all of HHSC for the year ended June 30, 2006. HHSC Board members and management believe that this is an acceptable level of billing error and actually confirms that the existing policies, procedures, and controls are in place and working effectively and efficiently.

13. The Corporation records cash receipts/contractual adjustments in a timely manner (see page 28 of the Draft Audit Report).

The receiving, recording, and reconciling of cash receipts is a manual process and therefore susceptible to human error. As a result, HHSC management has implemented adequate controls to timely prevent, detect, and deter misappropriations of cash resulting from errors or fraud. Based on the sample selection made by Accuity and the number of findings noted in the report (2/280 or .07% error rate), the controls over cash receipts appear to be working effectively and efficiently across all facilities within HHSC. Therefore management stands firm that our policies and procedures ensure that cash received by the business office and contractual adjustments are posted to the billing system in a timely manner.

Management Status Update:

It should be noted that as control of assets and processes is transferred to Regional System Boards as part of the implementation of Act 290, Regional System Boards will establish policies in these areas and will be responsible for performance.

14. The Corporation records payments for long-term care patients appropriately (see page 28 of the Draft Audit Report).

Although not material to the overall financial statement, the credit balance reported in the draft audit report was comprised of the following:

- \$201,636 – carried forward from the DOH community hospital at the inception of HHSC in 1996 (pre-HHSC)
- \$75,364 of current credit balance

Management Status Update:

HHSC implemented a policy in which all credit balances are reviewed on a monthly basis via a report issued by the Corporate revenue department. Subsequent to the audit, credit balances are researched and resolved in a timely manner at each facility. Management further asserts that the \$75,364 credit balance has been properly resolved and accounted for. In addition, \$70,524 of the pre-HHSC balance has also been resolved and accounted. Management will continue to monitor all credit balances.

15. Delays in the Engagement

The delays in the review and agreed-upon procedures engagement were due to the following:

- Ineffective and inefficient communication amongst all parties (no face to face meeting, except on January 24, 2008).
- Lack of industry knowledge on the part of Accuity (as demonstrated by the inappropriate procurement finding and the comment regarding the recording of revenue and receivables).
- Unreasonable demands made by Accuity and the Office of the Auditor regarding the signing of the management representation letter.
- Decentralized processes, which makes it time consuming and tedious to gather information (note that Act 290 will further decentralize HHSC).

The HHSC Board members and management would appreciate if all parties involved in this process would avoid such occurrences in the future and share in the responsibility for the delays incurred.

The goal of every audit or review should be to ensure completeness, accuracy, validity, and reporting timeliness. As such, HHSC Board members and management request that if there are future audits of HHSC that you consider implementing a standard accepted audit process that removes any real or implied restraints on members of your staff or firms contracted by you for providing full, timely reporting to management of emerging issues so that both parties can work together in the full evaluation of all relevant information.

16. Corporation provided representation as to the accuracy of financial statements to Deloitte & Touche but could not provide representation to Accuity on its financial review and undisclosed reporting (*see page 32 of the Draft Audit Report*).

Accuity did not conduct an audit of HHSC's financial statements but yet requested that HHSC management provide the same representations made to Deloitte & Touche for the years ended June 30, 2006 and June 30, 2005. We consider this request to be unprofessional. In addition, the means in which

Accuity tried to obtain the management representation letter from HHSC was inappropriate. Prior to signing any representation letter, management would need to review the draft audit report, including financial statements and disclosures. Under no circumstances were HHSC Board members or management privy to review Accuity's or the Office of the Auditor's report. Not having seen the financial statement and other reports to be issued by Accuity, HHSC management could not judge whether these reports were presented fairly. A premature signing of the management representation letter would have been irresponsible on the part of HHSC management.

17. The Corporation's Financial Statements Correctly Reported Bond Fund Appropriations for Fiscal Years ending June 30, 2006 and June 30, 2007 (see page 34 of the Draft Audit Report).

The draft audit report identified a significant accounting error that excluded \$4,013,827 in bond fund appropriations from HHSC's fiscal year 2006 financial statements. Besides the fact that the State Department of Accounting and General Services (DAGS) acknowledged in December 2007 that they improperly coded these bond funds, HHSC accounts for capital assets contributed by the State of Hawaii in accordance with GASB 33, "Accounting and Financial Reporting for Nonexchange Transactions," which governs capital asset contributions. Paragraph 21 of GASB 33 states, "Providers should recognize liabilities and expenses from government-mandated or voluntary nonexchange transactions, and recipients should recognize receivables and revenues when all applicable eligibility requirements, including time requirements, are met."

Regarding time requirements, DAGS would only provide capital asset resources for the fiscal year that is covered by the appropriation, limited to the amounts that would be expended in that year. Further, paragraph 64 of GASB 33 states, "The Board concluded that the conceptually appropriate recognition point for assets and liabilities in nonexchange transactions is when an enforceable legal claim to resources arises, based on the specifications of enabling legislation or contractual requirements.

However, the Board also concluded that if a claim to assets is not realizable (for example, enforcement of the claim is not probable), the transaction should not be recorded." In HHSC's case, it could not enforce a claim against the State for the unexpended appropriations that lapse at the end of a fiscal year. Thus, it should not record a receivable from the State of Hawaii and revenue for the difference between the total appropriations and the amounts expended by DAGS at the end of a fiscal year. The result is that HHSC should be recording an asset and revenue only for those amounts expended by DAGS.

The accounting for these capital asset transactions has been disclosed to our auditors, Deloitte & Touche LLP, and they have concurred that HHSC's

accounting for capital assets contributed by the State of Hawaii is in accordance with GASB 33. Based on management's review of the expenditures under the bond funds listed in your report, the total possible misstatement would be \$46,173.21, which is immaterial to HHSC's financial statements taken as a whole, and therefore not considered to be a significant accounting error.

18. The Corporation's executive total compensation is significantly less than executive compensation in the private sector and similar to others in government (see page 36 of the Draft Audit Report).

Compensation for corporate executives is closely monitored and approved by the HHSC Board of Directors. The Board of Directors established executive compensation packages after professional consultation with third party compensation consultant, William M. Mercer, in accordance with Chapter 323F, HRS. The existing executive compensation packages are much less than total compensation for counterparts in the private sector and comparable to compensation in the public sector.

See analysis below:

<u>Organization</u>	<u>Title</u>	<u>Salary + Bonus</u>	<u>No. of Employees</u>
Alexander & Baldwin	CEO	7,614,177	2,197
Bankoh	CEO	2,274,759	2,586
Hawaiian Telcom	CEO	1,900,000	1,700
HEI, Inc.	CEO	3,701,320	3,569
First Hawaiian Bank	CEO	1,200,000	2,219
Hawaiian Airlines	CEO	1,200,000	3,339
HMSA	CEO	1,100,000	1,696
Central Pacific Bank	CEO	1,392,752	972
Hawaii Pacific Health	CEO	816,382	5,313
Queen's Health System	CEO	692,727	3,000
Kamehameha Schools	CEO	474,240	1,804
Hawaii Pacific Health	EVP/CEO	510,032	5,313
UH Basketball	Coach	400,000	
UH School of Medicine	Dean	485,016***	
DOH Adult Mental Health	Director	320,076	339
HHSC	CEO	309,000**	3,600
UH School of Medicine	Assoc. Dean	307,000*	
Castle Hospital	CEO	691,775*	
DOH Mental Health	Psych Dir	248,400	21
UH School of Medicine	Director	213,216*	
State Hospital (Kaneohe)	Adminstr	181,128	507

APPENDIX to HHSC April 4, 2008
Response to 2008 Draft Legislative Audit Report

*Source: From Pacific Business News, April 9, 2006 and May 17, 2006; Honolulu Advertiser
4/1/07; IRS 2005 990 filings and other public records*

**2004 salary information*

***Plus \$45k housing allowance; no annual bonus*

****Plus additional compensation from private hospitals; 2004 information*

Note that the HHSC President & CEO is paid below the 25th percentile for similar positions in Hawaii or on the mainland.