



AUDITED CONSOLIDATED FINANCIAL
STATEMENTS

Hawai'i Pacific Health
Years Ended June 30, 2010 and 2009
With Report of Independent Auditors

Ernst & Young LLP



Hawai‘i Pacific Health

Audited Consolidated Financial Statements

Years Ended June 30, 2010 and 2009

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Report of Independent Auditors

Board of Directors
Hawai'i Pacific Health

We have audited the accompanying consolidated balance sheets of Hawai'i Pacific Health (the Company) as of June 30, 2010 and 2009, and the related consolidated statements of unrestricted revenues, expenses and other changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Hawai'i Pacific Health at June 30, 2010 and 2009, and the consolidated results of its operations, changes in its net assets, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

October 27, 2010

Hawai'i Pacific Health
Consolidated Balance Sheets

	June 30	
	2010	2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 45,817,717	\$ 70,896,405
Short-term investments	14,050,561	49,628
Patient accounts receivable, less allowance for uncollectible accounts (2010 – \$8,756,000; 2009 – \$7,929,000)	101,857,246	101,780,672
Due from third party payors	3,840,849	844,716
Pledges and other receivables	16,767,784	14,636,599
Inventories	11,672,693	10,344,573
Funds held by trustee under bond indenture agreement	10,458,840	8,074,341
Escrow funds held for bonds	–	132,281,496
Prepaid expenses and other	2,514,899	2,269,918
Total current assets	206,980,589	341,178,348
Assets whose use is limited or restricted:		
Board-designated:		
Cash and cash equivalents	13,113,787	13,652,314
Investments	162,031,993	146,503,333
	175,145,780	160,155,647
Funds held by trustee under bond indenture agreement	19,989,924	10,499,203
Restricted by donor or grantor:		
Cash and cash equivalents	192,964	215,831
Investments	11,739,674	11,361,296
Pledges receivable	7,453,480	–
	19,386,118	11,577,127
Total assets whose use is limited or restricted	214,521,822	182,231,977
Investments	41,331,342	10,353,426
Property and equipment, net	282,764,514	285,853,613
Other assets:		
Investments in joint ventures	9,056,198	3,874,078
Deposits and other	28,222,433	32,838,524
Goodwill	10,573,719	11,522,779
Total other assets	47,852,350	48,235,381
Total assets	\$ 793,450,617	\$ 867,852,745

	June 30	
	2010	2009
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 30,600,061	\$ 30,020,161
Payroll and related liabilities	55,872,165	50,788,201
Accrued expenses	36,387,991	39,585,885
Current portion of obligations under capital leases	–	49,193
Current portion of long-term debt	10,969,057	176,771,813
Total current liabilities	<u>133,829,274</u>	<u>297,215,253</u>
Long-term debt, less current portion	225,628,813	195,154,796
Other long-term liabilities	60,405,509	61,210,829
Accrued pension liability	112,035,314	67,638,060
Net assets:		
Unrestricted	231,274,206	221,164,801
Temporarily restricted	18,646,121	14,412,172
Permanently restricted	11,631,380	11,056,834
Total net assets	<u>261,551,707</u>	<u>246,633,807</u>

Total liabilities and net assets	<u><u>\$ 793,450,617</u></u>	<u><u>\$ 867,852,745</u></u>
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See accompanying notes.

Hawai'i Pacific Health

Consolidated Statements of Unrestricted Revenues, Expenses and Other Changes in Net Assets

	Year Ended June 30	
	2010	2009
Unrestricted revenues:		
Net patient service revenue	\$ 808,308,091	\$ 771,519,920
Premium revenue	7,375,645	5,523,399
Other revenues	20,167,501	18,960,816
Temporarily restricted net assets released from restrictions	16,083,459	16,340,621
Total unrestricted revenues	851,934,696	812,344,756
Expenses:		
Salaries and employee benefits	471,073,615	434,233,182
Provision for bad debts	25,065,703	23,247,151
Services	106,363,020	104,351,529
Supplies	106,620,557	98,107,192
Other purchases	41,484,551	48,333,561
Depreciation and amortization	38,969,891	40,123,558
Specific purpose projects/donations	16,083,459	16,340,621
Interest	12,665,996	15,719,345
Loss on disposals of property and equipment	108,393	297,223
Loss on extinguishment of debt	1,294,567	-
Other	7,337,782	4,498,597
Total expenses	827,067,534	785,251,959
Operating income	24,867,162	27,092,797
Unrestricted donations and contributions	833,853	681,122
Joint venture investment income	1,852,333	1,612,307
Gain on sale of joint venture, net of taxes	-	7,448,056
Investment income (loss)	11,215,279	(18,722,195)
Loss on basis agreement	-	(23,773,102)
Gain (loss) on swap arrangements	3,784,418	(3,187,048)
	17,685,883	(35,940,860)
Excess (deficiency) of revenues over expenses	42,553,045	(8,848,063)
Change in net unrealized gains (losses) on investments	4,623,170	(12,064,170)
Temporarily restricted net assets released from restrictions	1,521,326	629,425
Change in pension and postretirement liabilities	(31,326,021)	(64,341,765)
Change in interest rate swap value	(6,964,579)	1,042,870
Other changes in net assets	(297,536)	(109,358)
Increase (decrease) in unrestricted net assets	\$ 10,109,405	\$ (83,691,061)

Hawai‘i Pacific Health

Consolidated Statements of Unrestricted Revenues, Expenses and Other Changes in Net Assets (continued)

	Year Ended June 30	
	2010	2009
Temporarily restricted net assets:		
Restricted grants and contributions	\$ 20,934,639	\$ 12,082,215
Investment income (loss)	601,783	(649,963)
Change in net unrealized losses on investments	79,285	(1,176,367)
Net assets released from restrictions	(17,604,785)	(16,970,046)
Other changes in temporarily restricted net assets	223,027	360,730
Increase (decrease) in temporarily restricted net assets	4,233,949	(6,353,431)
Permanently restricted net assets:		
Restricted grants and contributions	163,424	1,887,113
Change in beneficial interest in perpetual trusts	411,122	(399,718)
Other changes in permanently restricted net assets	–	8,141
Increase in permanently restricted net assets	574,546	1,495,536
Increase (decrease) in net assets	14,917,900	(88,548,956)
Net assets at beginning of year	246,633,807	335,182,763
Net assets at end of year	\$ 261,551,707	\$ 246,633,807

See accompanying notes.

Hawai'i Pacific Health

Consolidated Statements of Cash Flows

	Year Ended June 30	
	2010	2009
Operating activities		
Increase (decrease) in net assets	\$ 14,917,900	\$ (88,548,956)
Adjustments to reconcile the increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	38,969,891	40,123,558
Provision for bad debts	25,065,703	23,247,151
Gain on sale of joint venture before taxes, net of other joint venture write-downs	–	(11,376,201)
Loss on disposals of property and equipment	108,393	297,223
Joint venture investment income	(1,852,333)	(1,612,307)
Net (gains) losses on alternative investments	(6,756,814)	16,606,566
Change in net unrealized (gains) losses on investments	(4,702,455)	13,240,537
Changes in operating assets and liabilities:		
Patient accounts receivable	(25,142,277)	(31,931,644)
Due from third party payors	(2,996,133)	5,712,520
Pledges and other receivables	(2,131,185)	(1,037,091)
Inventories and other assets	3,042,990	11,147,170
Restricted pledges receivable	(7,453,480)	–
Accounts payable and accrued expenses	2,545,454	(1,279,007)
Other long-term liabilities	(1,433,465)	(11,173,292)
Accrued pension liability	44,397,254	67,638,060
Net cash provided by operating activities	76,579,443	31,054,287
Investing activities		
Purchases of property and equipment	(35,040,125)	(30,874,427)
Proceeds from sale of assets	–	100,000
Proceeds from sale of joint venture	–	15,055,456
Net (contributions to) distributions from joint venture	(2,781,126)	41,986
Net (purchases) sales of investment securities	(44,978,849)	10,498,170
Assets whose use is limited or restricted:		
(Increase) decrease in funds held by trustee under bond indenture agreement	(11,875,220)	11,400,417
Net decrease (increase) in cash and cash equivalents	561,394	(1,466,870)
Net (purchases) sales of investment securities	(4,447,769)	6,441,263
Net cash (used in) provided by investing activities	(98,561,695)	11,195,995

Hawai'i Pacific Health

Consolidated Statements of Cash Flows (continued)

	Year Ended June 30	
	2010	2009
Financing activities		
Proceeds from long-term debt	\$ 98,522,814	\$113,875,000
Payment of long-term debt	(233,851,553)	(9,916,447)
Decrease (increase) in escrow funds held for bonds	132,281,496	(129,081,114)
Payment of capital lease obligations	(49,193)	(745,200)
Net cash used in financing activities	(3,096,436)	(25,867,761)
(Decrease) increase in cash and cash equivalents	(25,078,688)	16,382,521
Cash and cash equivalents at beginning of year	70,896,405	54,513,884
Cash and cash equivalents at end of year	\$ 45,817,717	\$ 70,896,405

See accompanying notes.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements

June 30, 2010

1. Organization and Summary of Accounting Policies

Hawai‘i Pacific Health (HPH) is the sole member of Kapi‘olani Medical Center for Women and Children (KMCWC), Kapi‘olani Medical Center at Pali Momi, dba Pali Momi Medical Center (KMCPM), Kapi‘olani Medical Specialists, Providers Insurance Corporation (PIC), Kapi‘olani Health Foundation (KHF), Straub Clinic & Hospital (SCH), Straub Foundation, Wilcox Memorial Hospital (WMH), Kauai Medical Clinic, Wilcox Health Foundation and other smaller health care related entities (some of which are for-profit) located in Hawaii. HPH and the above affiliates are collectively referred to as “the Company” and are consolidated in the accompanying consolidated financial statements. All inter-organizational transactions and balances have been eliminated in consolidation.

Except with regard to unrelated business income (UBI), which is taxed at corporate income tax rates, the Company’s not-for-profit organizations are (a) exempt from federal and state income taxes pursuant to Internal Revenue Code Section 501(a) and applicable state laws, and (b) generally exempt from Hawaii general excise tax on revenue related to their tax-exempt purpose.

The taxable affiliates of the Company utilize the liability method of accounting for income taxes. Under this method, deferred income tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities, and are measured using the currently exacted tax rates and laws. Valuation allowances are used to reduce deferred tax assets to their estimated net realizable values when management determines ultimate recovery of the deferred tax assets is not more likely than not to occur.

The accounting principles followed by the Company and the methods of applying those principles comply with accounting principles generally accepted in the United States and general practice within the healthcare industry. The significant policies are summarized below.

Cash Equivalents

Highly liquid investments with a maturity of three months or less when purchased are considered cash equivalents.

Inventories

Inventories, consisting of medical, surgical and other supplies, are stated at the lower of cost (first-in, first-out method) or market.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, ranging from 2 to 75 years for buildings and improvements, and 3 to 20 years for equipment. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated statements of unrestricted revenues, expenses and other changes in net assets. Interest incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support, and are excluded from the excess (deficiency) of revenues over expenses. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used, and gifts of cash or other assets that must be used to acquire long-lived assets, are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Investments

Short-term investments include investments with maturities between three months and one year at the date of purchase. Such amounts are stated at cost which approximates fair value.

Investments in equity securities with readily determinable fair values, and all investments in debt securities, are measured at fair value in the consolidated balance sheets. Fair value is established based on quoted prices from established securities exchanges or based on quoted market prices of similar instruments. The Company determined that all marketable securities held at June 30, 2010 and 2009, are designated as other than trading. Accordingly, unrealized gains and losses on investments, except for other-than-temporary declines in fair value, are excluded from the excess (deficiency) of revenues over expenses.

The Company holds certain investments which are classified as alternative investments and include trust funds and limited partnerships that seek positive returns regardless of market direction and which are not restricted to any particular asset class. Some of these alternative investments invest in other similar partnerships or funds and employ a “Fund of Funds” strategy.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Some of these alternative investments have specific industry focus in their investment assets. At the investment manager's direction, these alternative investments may invest in both registered and non-registered securities in the U.S. and globally, with exposure to both emerging and developed markets. These entities employ a range of investment strategies including but not limited to long/short equity positions, derivatives, forward and futures contracts, and currency hedges. The Company accounts for its ownership interests in these alternative investments under the equity method of accounting, which is included in investment income (loss) in the consolidated statements of unrestricted revenues, expenses and other changes in net assets.

As of both June 30, 2010 and 2009, the alternative investments comprised approximately 44% of the Company's total investments, including assets whose use is limited or restricted.

Investment income (loss) (including realized gains and losses on investments, gains and losses on alternative investments, other-than-temporary declines in fair value, interest and dividends) is included in the excess (deficiency) of revenues over expenses unless restricted by donor or law.

The Company determines whether a decline in the fair market value of investments below the cost basis is other-than-temporary based on objective evidence as well as subjective factors including knowledge of recent events and assumptions of future events. If the decline in fair value is judged to be other-than-temporary, the cost basis of the individual security is written down to fair value as a new cost basis. The Company recorded other-than-temporary losses of approximately \$7,440,000 in 2009. The Company determined that there were no other-than-temporary losses during 2010.

Income on investments of donor-restricted funds and endowment funds is recorded as an increase in unrestricted net assets, unless restricted by the donor or law. Realized gains and losses are computed using the weighted average method.

The Company uses multiple investment managers to diversify its investment portfolios. In accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320, *Investments – Debt and Equity Securities*, the Company reports mutual funds with underlying investments in debt securities as equity securities.

Investments in joint ventures which are 20–50% owned or where the Company can exert control over the joint venture are recorded under the equity method of accounting which approximates the Company's equity in their underlying net book values.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Board-Designated Assets

Board-designated assets consist of unrestricted net assets and accumulated income which have been designated by the Board of Directors for expansion and support of fundraising activities. The Board can redesignate these assets at its discretion.

Contributions

Contributions received, including unconditional promises to give, are recognized as revenue in the period received at their fair value. Fair value is measured as the present value of estimated cash flows using a discount rate commensurate with the risks involved. Pledges receivable are stated at their estimated net realizable value and are included in pledges and other receivables and restricted pledges receivable in the accompanying consolidated balance sheets.

The amounts of pledges receivable as of June 30, 2010 are as follows:

Receivable in less than one year	\$ 1,059,769
Receivable in one to five years	7,003,233
Thereafter	818,000
	<hr/>
	8,881,002
Less present value discount	740,520
Less allowance for uncollectible pledges	52,952
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	<u>\$ 8,087,530</u>

Temporarily and Permanently Restricted Net Assets

Restricted net assets consist of donations and other funds where donor restrictions have been imposed as to their use for specific purposes. Temporarily restricted net assets consist of those net assets whose use by the Company has been limited by donors to a specific purpose or time period. When a donor stipulated time restriction ends or a purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of unrestricted revenues, expenses and other changes in net assets as net assets released from restrictions. Permanently restricted net assets consist of the principal amount of net assets whose use by donors has been restricted in perpetuity. Investment income related to permanently restricted net assets is reported as temporarily restricted in the consolidated statements of unrestricted revenues, expenses and other changes in net assets under the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA).

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Net Patient Service Revenue, Premium Revenue and Patient Accounts Receivable

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

The provision for bad debts expense is based upon management's assessment of historical and expected net collections, taking into consideration historical business and economic trends, trends in healthcare coverages and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for uncollectible accounts to establish an appropriate allowance for uncollectible accounts. Bad debt consists of services for which the Company anticipated but did not receive payment because of patients' unwillingness to pay. Bad debt also includes services for medically indigent and/or uninsured patients who are unable to pay and who might have qualified for charity care had the patient self-identified themselves as medically indigent along with providing information so that proper means testing could have been accomplished to qualify the patient for charity care.

The Company has agreements with various health maintenance organizations (HMOs) to provide medical services to subscribing participants. For the majority of its HMO business, the Company receives fee-for-service payments which are recorded as net patient service revenue in the consolidated statements of unrestricted revenues, expenses and other changes in net assets.

Significant concentrations of patient accounts receivable include Hawaii Medical Service Association (HMSA) – 23% and 24%, QUEST and QUEST Expanded Access plans – 22% and 19%, Medicaid – 3% and 6%, and Medicare – 25% and 26% as of June 30, 2010 and 2009, respectively.

Government Reimbursement Programs

The Company renders services to patients under contractual arrangements with the Medicare and Medicaid programs. The percentage of patient service revenue applicable to the Medicare and Medicaid programs, respectively, approximated 32% and 2% in 2010, and 31% and 5% in 2009. Medicare acute inpatient services are reimbursed based on clinical, diagnostic, and other factors; and for Medicaid a per diem rate for routine services and a per discharge rate for ancillary services. Outpatient services and defined capital costs related to Medicare and Medicaid beneficiaries are paid based upon a prospective payment system, fee schedules or a cost

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

reimbursement method. The Company is reimbursed for these reimbursable items at an interim rate; final settlement is determined after annual cost reports submitted by the Company are audited by the fiscal intermediary. Normal estimation differences between final settlements and amounts accrued in previous years due to audit adjustments recorded by the fiscal intermediary are reported as current year changes to net patient service revenues and amounted to a net increase of approximately \$2,842,000 in 2010 and \$715,000 in 2009. The Company has the ability to appeal the adjustments based on a process established by Medicare and Medicaid.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The Company believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigation involving allegations of potential wrongdoing that would have a material impact on the consolidated financial statements that have not been recorded. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

In 1995, the Company entered into several agreements with health plans to provide hospital services to plan members who are eligible to participate in the State of Hawaii's QUEST program, a Section 1115 Medicaid waiver program. The percentage of patient service revenue applicable to the QUEST program approximated 19% in 2010 and 15% in 2009.

Charity Care

The Company will treat patients regardless of their ability to pay. An established charity care policy sets guidelines to determine which patients qualify for care given at no charge. Since the Company does not pursue collection from qualified charity care patients, related charges are not reported as revenue. Recorded charity care provided in both 2010 and 2009 comprised less than 1% of total net patient service revenue.

Collective Bargaining Agreements

The Company has several collective bargaining agreements covering approximately 40% of the Company's labor force. As of June 30, 2010, three collective bargaining agreements with two unions, or approximately 12% of the Company's labor force, will expire within one year.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Advertising Expense

The Company expenses advertising costs as incurred. Advertising expense was approximately \$3,100,000 in 2010 and \$4,200,000 in 2009.

Deferred Financing Costs

Costs incurred in obtaining long-term financing are deferred and amortized over the terms of the related obligations using the effective-interest method.

Goodwill

Goodwill was recorded as a result of the acquisition of certain assets and assumption of certain liabilities from Straub Clinic & Hospital, Inc. and its wholly-owned subsidiaries (SCHI) on December 23, 2001. Goodwill is amortized on a straight-line basis over a period of 20 years.

Accounting for the Impairment or Disposal of Long-Lived Assets

The Company accounts for the impairment or disposal of long-lived assets in accordance with FASB ASC 360, *Property, Plant and Equipment*. FASB ASC 360 uses a future cash flow model to determine whether assets have been impaired. The Company reviews long-lived assets for circumstances which could indicate carrying values may not be recoverable.

Excess (Deficiency) of Revenues over Expenses

The consolidated statements of unrestricted revenues, expenses and other changes in net assets include the excess (deficiency) of revenues over expenses. Changes in unrestricted net assets which are excluded from the excess (deficiency) of revenues over expenses, consistent with industry practice, include unrealized gains and losses (except for other-than-temporary declines in fair value) on investments in other than trading securities, contributions of long-lived assets (including assets acquired using contributions which by donor restrictions were to be used for the purposes of acquiring such assets), change in pension and postretirement liabilities, and gains or losses associated with derivatives that qualify as effective cash flow hedges.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

Fair Value of Financial Instruments

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, receivables, accounts payable and accrued expenses approximate fair value due to the short-term nature of these instruments.

Fair values for long-term debt are estimated using quoted market prices of similar types of borrowings (see Note 7).

Subsequent Events

Subsequent events have been evaluated through October 27, 2010, the date these consolidated financial statements were issued.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain 2009 balances have been reclassified to conform with the 2010 presentation.

Adoption of New Accounting Principles

In June 2009, FASB issued Statement of Financial Accounting Standard No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 168). SFAS No. 168 establishes the FASB ASC as the single source of authoritative U.S. GAAP to be applied by nongovernmental entities. SFAS No. 168 is effective for financial statements issued for annual periods ending after September 15, 2009. The Company adopted SFAS No. 168 and as a result, has included FASB ASC references where applicable.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

In accordance with the provisions of FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, the Company elected to defer implementation of FASB ASC 820-10 as it relates to the Company's non-financial assets and liabilities that are not permitted or required to be measured at fair value on a recurring basis. The Company adopted the provisions of FSP FAS 157-2 effective July 1, 2009. Adoption of FSP FAS 157-2 did not have a material effect on the consolidated financial statements of the Company.

In September 2009, the FASB issued Accounting Standards Update 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* (ASU 2009-12). ASU 2009-12 provides amendments to FASB ASC 820, *Fair Value Measurements and Disclosures*. The amendments permit, as a practical expedient, a reporting entity to estimate the fair value of an investment that is within the scope of ASU 2009-12 using the net asset value per share (or its equivalent) of the investment if the net asset value of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services – Investment Companies*, as of the reporting entity's measurement date. FASB ASC 946 requires investment companies to report their investment assets at fair value in accordance with the principles of FASB ASC 820. The amendments also require disclosures regarding the attributes of investments within the scope of ASU 2009-12, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded capital commitments, and the investment strategies of the investees. The disclosures are required (by major category) for all investments within the scope of ASU 2009-12 regardless of whether the fair value of the investment is measured using the practical expedient. The amended guidance is effective for interim and annual periods ending after December 15, 2009; however, early application is permitted if financial statements for prior periods have not been issued. Entities that elect to early adopt may defer the additional disclosure requirements of ASU 2009-12 until the effective date. In 2009, the Company elected to early adopt the amended guidance and therefore, as a practical expedient, measures the fair value of the Company's pension plan investments within the scope of ASU 2009-12, based on the unadjusted net asset value per share of the investments (or its equivalent) as of the measurement date. The Company adopted the disclosure provisions required in the amended guidance in 2010.

The Company adopted the provisions of FASB ASC 715-20-50, *Compensation – Retirement Benefits*, related to additional disclosures for plan assets of defined benefit pension or other postretirement plans. FASB ASC 715-20-50 is effective for financial statements issued for fiscal years ending after December 15, 2009. The adoption of FASB ASC 715-20-50 had no effect on the consolidated financial statements.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

On July 1, 2009, the State of Hawaii adopted UPMIFA. The Company classifies donor-restricted endowment funds of perpetual duration as permanently restricted net assets in accordance with explicit donor stipulations, or based on the Board of Directors' determination of the amount that must be preserved consistent with relevant law (see Note 15). The adoption of UPMIFA did not have a material effect on the consolidated financial statements of the Company.

In April 2009, the FASB issued FASB Staff Position 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP 157-4), currently included in FASB ASC 820. FSP 157-4 amended FASB Statement No. 157 (codified as FASB ASC 820) to provide additional guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to its normal market activity. FSP 157-4 also provided additional guidance on circumstances that may indicate that a transaction is not orderly and on defining major categories of debt and equity securities to comply with the disclosure requirements of FASB ASC 820. The Company adopted the guidance in FSP 157-4 for the reporting period ended June 30, 2010. Adoption of FSP 157-4 did not have an effect on the consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update 2010-06, *Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 amended ASC 820 to clarify certain existing fair value disclosures and require a number of additional disclosures. The guidance in ASU 2010-06 clarified that disclosures should be presented separately for each "class" of assets and liabilities measured at fair value and provided guidance on how to determine the appropriate classes of assets and liabilities to be presented. ASU 2010-06 also clarified the requirement for entities to disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. In addition, ASU 2010-06 introduced new requirements to disclose the amounts (on a gross basis) and reasons for any significant transfers between Levels 1, 2 and 3 of the fair value hierarchy and presents information regarding the purchases, sales, issuances and settlements of Level 3 assets and liabilities on a gross basis. With the exception of the requirement to present changes in Level 3 measurements on a gross basis, which is delayed until 2011, the guidance in ASU 2010-06 is effective for reporting periods beginning after December 15, 2009. Management is currently evaluating the effect that the provisions of ASU 2010-06 will have on the consolidated financial statements.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

1. Organization and Summary of Accounting Policies (continued)

In May 2009, the FASB issued FASB ASC 958-805, *Not-for-Profit Entities – Business Combinations*, which establishes the framework for financial accounting and reporting for not-for-profit mergers and acquisitions and intangible assets. FASB ASC 958-805 is effective for mergers and acquisitions on or after December 15, 2009. Further, in connection with the adoption of FASB ASC 958-805, not-for-profit organizations will no longer amortize goodwill, but will be subject to an annual impairment test. The Company is currently evaluating the effect of FASB ASC 958-805 on its consolidated financial statements.

In August 2010, FASB issued ASU 2010-23, *Measuring Charity Care for Disclosures* (ASU 2010-23). ASU 2010-23 requires that the level of charity care provided be presented based on the direct and indirect costs of the charity services provided. ASU 2010-23 is effective for years beginning on or after December 15, 2010. The Company is currently evaluating the effect of ASU 2010-23 on the notes accompanying the consolidated financial statements.

In August 2010, the FASB issued Accounting Standards Update 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries* (ASU 2010-24). ASU 2010-24 clarifies that health care entities should not net insurance recoveries against related claim liabilities. Additionally, the amount of the claim liability should be determined without consideration of insurance recoveries. ASU 2010-24 is effective for years ending after December 15, 2010. The Company is currently evaluating the effect of ASU 2010-24 on its consolidated financial statements.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

2. Investments

Investments consist of the following:

	June 30	
	2010	2009
Board-designated:		
Equity securities	\$ 76,078,336	\$ 67,645,908
Trust funds and limited partnerships (alternative investments)	71,168,051	64,855,570
Cash surrender value of life insurance policies	14,785,606	14,001,855
	<u>162,031,993</u>	<u>146,503,333</u>
Funds held by trustee under bond indenture agreement:		
Cash and short-term investments	28,628,726	16,753,506
Fixed income securities	1,820,038	1,820,038
	<u>30,448,764</u>	<u>18,573,544</u>
Escrow funds held for bonds - Cash and short-term investments	-	132,281,496
Restricted by donor or grantor:		
Certificate of deposit	600,000	600,000
Cash and short-term investments	306,495	381,173
Equity securities	3,605,145	3,516,964
Beneficial interest in perpetual trusts (comprised of fixed income and equity securities)	4,060,244	3,883,600
Trust funds and limited partnerships (alternative investments)	2,749,208	2,578,093
Debt securities	418,582	401,466
	<u>11,739,674</u>	<u>11,361,296</u>
Unrestricted – undesignated:		
Certificates of deposit	24,050,561	50,561
Equity securities	4,519,335	4,175,367
Debt securities	20,953,686	521,444
Charitable remainder trust assets	45,000	45,000
Trust funds and limited partnerships (alternative investments)	2,200,938	2,117,866
Money market funds	491,875	479,631
Cash surrender value of life insurance policies	3,120,508	3,013,185
	<u>55,381,903</u>	<u>10,403,054</u>
	<u>\$ 259,602,334</u>	<u>\$ 319,122,723</u>

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

2. Investments (continued)

Investment income (loss) for assets limited or restricted as to use, cash equivalents, and other investments are comprised of the following:

	Year Ended June 30			
	2010		2009	
	Unrestricted	Temporarily Restricted	Unrestricted	Temporarily Restricted
Dividends and interest	\$ 4,128,371	\$ 234,462	\$ 6,312,498	\$ 236,596
Realized gains (losses)	688,332	9,083	(1,663,273)	(211,826)
Other-than-temporary losses	–	–	(7,439,587)	–
Net gains (losses) on alternative investments	6,398,576	358,238	(15,931,833)	(674,733)
	\$11,215,279	\$ 601,783	\$ (18,722,195)	\$ (649,963)

	Year Ended June 30	
	2010	2009
Unrealized gains (losses) – change in:		
Unrestricted net assets	\$ 4,623,170	\$ (12,064,170)
Temporarily restricted net assets	79,285	(1,176,367)
	\$ 4,702,455	\$ (13,240,537)

The following table summarizes the unrealized losses on investments held at June 30:

Description	2010					
	Less than Twelve Months		Twelve Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Equity securities	\$ 31,828,069	\$ 2,537,356	\$ –	\$ –	\$ 31,828,069	\$ 2,537,356

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

2. Investments (continued)

Description	2009					
	Less than Twelve Months		Twelve Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Equity securities	\$ 28,652,448	\$ 3,679,552	\$ –	\$ –	\$ 28,652,448	\$ 3,679,552
Debt securities	–	–	26,067,920	532,644	26,067,920	532,644
Total	\$ 28,652,448	\$ 3,679,552	\$ 26,067,920	\$ 532,644	\$ 54,720,368	\$ 4,212,196

Management has concluded that the current economic improvement will enable the Company to recover the unrealized losses. This conclusion was based on a number of factors including: (1) the significance of the difference between cost and fair value of the investment; and (2) the time period for which fair value was lower than cost.

3. Fair Value

FASB ASC 820-10 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, FASB ASC 820-10 establishes a three-tier fair value hierarchy and prioritizes the inputs used in measuring fair value as follows:

Level 1 – Pricing is based on observable inputs such as quoted prices in active markets. Examples of financial assets and liabilities in Level 1 include U.S. Treasury securities, mutual funds, money market funds, and listed equities.

Level 2 – Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full contractual term of the assets or liabilities. Examples of financial assets and liabilities in Level 2 include certificates of deposit, asset-backed securities, corporate bonds, foreign bonds, municipal bonds, interest rate swaps and beneficial interest in perpetual trusts.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

3. Fair Value (continued)

Level 3 – Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the instrument. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. Level 3 fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third-party appraisals, discounted cash flow models, and fund manager estimates.

Assets and liabilities measured at fair value are based on one or more of the three valuation techniques noted in FASB ASC 820-10. The three valuation techniques are identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

Market approach – Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Cost approach – Amount that would be required to replace the service capacity of an asset (replacement cost).

Income approach – Techniques to convert future amounts to a single present value amount based on market expectations (including present value techniques, option-pricing and excess earnings models for intangibles).

As of June 30, 2010 and 2009, the Company's alternative investments amounting to approximately \$76,118,000 and \$69,522,000, respectively, are accounted for using the equity method of accounting. Approximately \$71,168,000 and \$64,856,000 of the Company's alternative investments are reported in assets whose use is Board-designated, \$2,749,000 and \$2,578,000 are restricted by donor or grantor and \$2,201,000 and \$2,118,000 are unrestricted-undesigned as of June 30, 2010 and 2009, respectively. Since alternative investments are accounted for using the equity method of accounting, which is not a fair value measure, they are omitted from the following table. As of June 30, 2010 and 2009, the Company's investments in cash surrender values of life insurance policies amounting to approximately \$17,906,000 and \$17,015,000, respectively, are also omitted from the following table as they are accounted for as life insurance contracts. Approximately \$14,785,000 and \$14,002,000 of the Company's cash surrender values of life insurance policies are reported in assets whose use is Board-designated and \$3,121,000 and \$3,013,000 are unrestricted-undesigned as of June 30, 2010 and 2009, respectively.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

3. Fair Value (continued)

The tables below present the Company's fair value measurements on a recurring basis as of June 30:

Description	June 30, 2010				Valuation Technique
	Total	Level 1	Level 2	Level 3	
Board-designated investments:					
Equity securities –					
Large cap	\$ 3,003,443	\$ 3,003,443	\$ –	\$ –	a
Opportunistic	6,812,120	6,812,120	–	–	a
Global equity	22,751,775	22,751,775	–	–	a
Inflation hedging	8,464,295	8,464,295	–	–	a
Fixed income	27,509,445	27,509,445	–	–	a
Global balanced	7,537,258	7,537,258	–	–	a
Funds held by trustee under bond indenture agreement:					
Cash and short term investments	28,628,726	21,198,726	7,430,000	–	a
Debt securities – guaranteed investment contracts	1,820,038	–	1,820,038	–	a
Investments restricted by donor or grantor:					
Equity securities –					
Large cap	825,526	825,526	–	–	a
Opportunistic	254,294	254,294	–	–	a
Global equity	849,316	849,316	–	–	a
Inflation hedging	322,161	322,161	–	–	a
Fixed income	1,062,685	1,062,685	–	–	a
Global balanced	291,163	291,163	–	–	a
Debt securities –					
Asset-backed securities	71,494	–	71,494	–	a
U.S. Treasury obligation	66,470	66,470	–	–	a
Corporate bonds	250,438	–	250,438	–	a
Foreign bonds	30,180	–	30,180	–	a
Certificates of deposit	600,000	–	600,000	–	a
Cash and short-term investments	306,495	306,494	–	–	a
Beneficial interest in perpetual trusts	4,060,244	–	4,060,244	–	c

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

3. Fair Value (continued)

Description	June 30, 2010 (continued)				Valuation Technique
	Total	Level 1	Level 2	Level 3	
Unrestricted investments:					
Certificates of deposit	\$ 24,050,561	\$ –	\$24,050,561	\$ –	a
Money market funds	491,875	491,875	–	–	a
Equity securities –					
Large cap	939,385	939,385	–	–	a
Opportunistic	208,674	208,674	–	–	a
Global Equity	696,951	696,951	–	–	a
Inflation hedging	260,682	260,682	–	–	a
Fixed income	2,180,547	2,180,547	–	–	a
Global balanced	233,096	233,096	–	–	a
Debt securities –					
U.S. Treasury obligations	4,743,485	4,743,485	–	–	a
Asset-backed securities	3,013,239	–	3,013,239	–	a
U.S. Commercial paper	6,923,505	6,923,505	–	–	a
Corporate bonds	6,227,611	–	6,227,611	–	a
Foreign bonds	45,846	–	45,846	–	a
Charitable remainder trust assets	45,000	–	45,000	–	c
2004 Interest rate swaps, including collateral posted	(1,135,000)	–	(1,135,000)	–	a

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

3. Fair Value (continued)

Description	June 30, 2009				Valuation Technique
	Total	Level 1	Level 2	Level 3	
Short-term investments	\$ 49,628	\$ 49,628	\$ –	\$ –	a
Investments designated by Board	67,645,908	67,645,908	–	–	a
Funds held by trustee under bond indenture agreement	18,573,544	9,323,506	9,250,038	–	a
Escrow funds held for bonds	132,281,496	132,281,496	–	–	a
Investments restricted by donor or grantor	8,783,203	4,505,772	4,277,431	–	a, c
Unrestricted investments	5,222,375	4,821,695	400,680	–	a
Interest rate swaps, including collateral posted	3,547,501	–	3,547,501	–	a

- a) Market approach
- b) Cost approach
- c) Income approach

The Company received restricted pledges and contributions amounting to \$12,528,791 in 2010 and \$4,478,734 in 2009 that were subject to fair value measurement in accordance with FASB ASC 820-10 upon initial measurement. The restricted contributions were measured based on the actual cash received, or for pledge receivables, using discounted cash flow projections as outlined in the income approach. Approximately \$8,087,530 and \$1,216,000 of the restricted contributions received, were recorded as pledges receivable as of June 30, 2010 and 2009, respectively.

As of both June 30, 2010 and 2009, the uncollateralized portion of the Company’s swaps subject to nonperformance risk was approximately \$3,000,000. The resulting reduction in unrealized loss on interest swaps due to this nonperformance risk arising from the Company’s own credit risk was not material and no adjustment was recorded in excess (deficiency) of revenue over expenses for the years ended June 30, 2010 and 2009.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

4. Property and Equipment

Property and equipment are summarized as follows:

	June 30	
	2010	2009
Land and land improvements	\$ 39,394,608	\$ 37,894,176
Buildings and improvements	348,339,819	342,650,040
Equipment	327,602,547	309,140,126
Capitalized leases	3,107,549	6,506,487
Construction in progress	15,947,396	7,731,134
	734,391,919	703,921,963
Less amortization and accumulated depreciation	451,627,405	418,068,350
	<u>\$282,764,514</u>	<u>\$ 285,853,613</u>

5. Employee Benefit Plans

Eligible employees of the Company are covered under the Hawaii Pacific Health Retirement Plan, a noncontributory defined benefit pension plan. Benefits are based on years of service and a percentage of the employee's compensation. The Company's policy is to accrue actuarially determined net periodic pension costs and to annually contribute an amount within regulatory guidelines.

Included in net assets at June 30, 2010 are the following amounts that have not yet been recognized in net periodic pension cost: unrecognized prior service credits of \$2,968,811 and unrecognized actuarial losses of \$95,548,832. The unrecognized prior service credit and actuarial loss included in net assets and expected to be recognized in net periodic pension cost during the year ending June 30, 2011 is \$4,614,864.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

Reconciliation of Funded Status and Accumulated Benefit Obligation

The reconciliation of the beginning and ending balances of the projected benefit obligation and the fair value of plans assets for the year ended June 30 and the accumulated benefit obligation at June 30 is as follows:

	Year Ended June 30	
	2010	2009
Funded Status		
Projected benefit obligation:		
Benefit obligation, at beginning of year	\$ 193,578,250	\$ 160,227,171
Service cost	8,336,734	6,697,145
Interest cost	11,743,411	10,613,941
Actuarial loss	32,543,111	23,084,589
Benefits paid	(7,465,838)	(7,044,596)
Benefit obligation at end of year	238,735,668	193,578,250
 Fair value of plan assets:		
Fair value of plan assets, at beginning of year	125,940,190	162,854,038
Actual return (loss) on plan assets	8,226,002	(29,869,252)
Benefits paid	(7,465,838)	(7,044,596)
Fair value of plan assets at end of year	126,700,354	125,940,190
Funded status, end of year	\$(112,035,314)	\$ (67,638,060)
 Accumulated benefit obligation	\$ 206,012,371	\$ 172,439,896

The underfunded status of the plan of \$112,035,314 and \$67,638,060 at June 30, 2010 and 2009, respectively, is recognized in the accompanying consolidated balance sheets as accrued pension liability. No plan assets are expected to be returned to the Company during the year ended June 30, 2011.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

Components of Net Periodic Benefit Cost

	Year Ended June 30	
	2010	2009
Service cost	\$ 8,336,734	\$ 6,697,145
Interest cost	11,743,411	10,613,941
Expected return on plan assets	(9,717,343)	(12,673,467)
Recognized prior service cost	(280,269)	(280,266)
Recognized net loss	3,058,060	—
Net periodic benefit cost	\$13,140,593	\$ 4,357,353

Weighted Average Assumptions Used to Determine Benefit Obligations

	June 30	
	2010	2009
Discount rate	5.50%	6.21%
Rate of compensation increase	3.50%	3.50%

Weighted Average Assumptions Used to Determine Net Periodic Benefit Cost

	Year Ended June 30	
	2010	2009
Discount rate	6.21%	6.82%
Expected return on plan assets	8.00%	8.00%
Rate of compensation increase	3.50%	3.50%

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

Asset Allocations

The assets of the plan are held by the plan trustee in the Hawai‘i Pacific Health combined pension fund. Oversight of the combined pension fund assets is provided by the Hawai‘i Pacific Health Investment Committee and the Hawai‘i Pacific Health Finance Committee of the Board of Directors. The long-term financial objectives of the combined pension fund are to comply with regulatory funding requirements and balance liquidity needs to meet benefit and expense obligations when due with long-term investment return goals to satisfy future plan obligations.

The long-term investment objective is to earn an average, real return of 5%, after adjusting for inflation and management fees, over long time periods. In order to achieve this objective, the fund needs to exceed the investment objectives in certain periods in order to compensate for shortfalls in other periods. This implies a higher average allocation to equity securities. The Investment Committee’s investment policy sets a target for the weighted average asset allocation of 70% equity securities and 30% fixed income securities.

The expected return on plan assets of 8% was developed based upon analysis of historical market returns, current market conditions, targeted future asset allocations, the plan assets’ past performance, and expectations on potential future market returns. The expected return represents a long-term average view of the performance of the plan assets which may not be achieved during a given plan year.

The weighted average target asset allocation compared to actual asset allocations at June 30, by major asset category, are as follows:

Major Asset Category	Target Allocation	Percentage of Actual Plan Assets at June 30	
	2010	2010	2009
U.S. equity	22%	20%	18%
Global equity	23	25	23
Fixed income	25	26	30
Inflation hedging	10	6	5
Marketable alternative investments	15	14	–
Real estate	–	6	6
Cash and cash equivalents	5	3	18
	100%	100%	100%

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

The table below presents the plan’s assets measured at fair value on a recurring basis as of June 30, 2010:

	Total	Level 1	Level 2	Level 3
Equity securities -				
Core	\$ 8,955,315	\$ 8,955,315	\$ —	\$ —
Value	2,450,483	2,450,483	—	—
Opportunistic	7,783,384	7,783,384	—	—
Global	31,057,507	31,057,507	—	—
Fixed income	23,200,675	23,200,675	—	—
Inflation hedging	3,874,253	3,874,253	—	—
Alternative investments -				
U.S. equity growth	5,939,283	—	5,939,283	—
Fixed income	10,197,767	—	10,197,767	—
Inflation hedging	3,607,019	—	3,607,019	—
Diversified arbitrage/event-driven	10,343,733	—	—	10,343,733
Distressed	1,450,394	—	—	1,450,394
Global long/short	4,712,550	—	956,005	3,756,545
Opportunistic	890,949	—	—	890,949
Real estate	7,200,000	—	7,200,000	—
Cash and cash equivalents	5,037,042	5,037,042	—	—
Total	<u>\$ 126,700,354</u>	<u>\$ 82,358,659</u>	<u>\$ 27,900,074</u>	<u>\$ 16,441,621</u>

In accordance with FASB ASC 320, the plan’s mutual funds with underlying investments in debt securities are reported as equity securities which differs from its target asset allocation reporting.

The plan has classified its common stock, mutual funds, money market funds and U.S. agency securities which are considered highly liquid and easily tradable as Level 1 within the fair value hierarchy. These securities are valued using inputs observable in active markets for identical securities. The plan’s investments in real estate and certain alternative investments are classified as Level 2. Real estate is valued via an appraisal using inputs observable in active markets for similar properties. These alternative investments are valued using net asset value as of the measurement date as a practical expedient and these investments may be redeemed in the near

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

term. Certain alternative investments are classified as Level 3. These alternative investments are valued using net asset value as of the measurement date as a practical expedient and these investments may not be redeemed in the near term.

The following is a summary of changes in the fair value of the plan's Level 3 assets for the year ended June 30, 2010:

	Fair value June 30, 2009	Unrealized gains (losses) related to assets held at June 30, 2010	Realized losses	Purchases and (sales), net	Fair value June 30, 2010
Alternative investments:					
U.S. equity growth	\$ 2,090,895	\$ 418,310	\$ -	\$ (2,509,205)	\$ -
Diversified					
arbitrage/event-driven	-	(156,267)	-	10,500,000	10,343,733
Distressed	-	(49,606)	-	1,500,000	1,450,394
Global long/short	-	(241,400)	(2,055)	4,000,000	3,756,545
Opportunistic	-	(109,051)	-	1,000,000	890,949
	<u>\$ 2,090,895</u>	<u>\$ (138,014)</u>	<u>\$ (2,055)</u>	<u>\$ 14,490,795</u>	<u>\$ 16,441,621</u>

Certain of the plan's alternative investments report fair value using a calculated net asset value per share or its equivalent. The following table and explanations identify attributes relating to the nature and risk of such investments at June 30, 2010:

	Fair value	Redemption frequency (if currently eligible)	Redemption notice period (if currently eligible)	Redemption restrictions and expiration of restriction
U.S. equity growth	\$ 5,939,283	-	30 days	-
Fixed income	10,197,767	-	10 business days	-
Inflation hedging	3,607,019	-	0-10 business days	-
Diversified arbitrage/ event-driven	10,343,733	Quarterly, annually	45 - 65 days	Side pockets, gates, hard/soft lock-ups; 9/30/2010, 12/31/2010, 3/31/2011, 3/31/2012
Distressed	1,450,394	Annually	90 days	Side pockets, hard lock- ups; 12/31/2011
Global long/short	4,712,550	Quarterly, annually	30 -90 days	Side pockets, gates, hard/soft lock-ups; 3/31/2011, 6/30/2011
Opportunistic	890,949	Annually	90 days	Side pockets, gates; 3/31/2011
	<u>\$ 37,141,695</u>			

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

U.S. equity growth: This category has emphasis on equities of companies with rapid earnings growth and high multiples of earnings, dividends, and book values.

Fixed income: This category has portfolios which seek to exploit mispricings in fixed income securities, utilizing a variety of investment instruments, including corporate and municipal bonds, sovereign debt, mortgage-backed securities, swaps and options. These managers often utilize leverage to magnify their returns.

Inflation hedging: This category has portfolios that seek to mitigate the risks posed by heightened inflation mainly the threat inflation poses to maintaining the purchasing power of a portfolio over time. Inflation hedging strategies generally revolve around investment in tangible assets such as energy, real estate and commodities. These types of assets generally see their values increase in line with inflation. (They are more highly correlated with inflation than many other assets.)

Diversified arbitrage: This category has multi-strategy portfolios which have broad investment parameters, which seek to profit from mispricings across asset classes and strategies. These managers invest their capital across multiple strategies at any given time.

Event-driven: This category has multi-strategy portfolios which seek to exploit security mispricings caused by mergers and acquisitions, spin-offs, tracking stocks, accounting write-offs, reorganizations, bankruptcies, share buybacks and special dividends.

Distressed: This category has portfolios consisting primarily of investments in debt securities of companies that are experiencing business, financial, market or legal uncertainties, attempting to capture the difference between the market price of security or debt obligations and their underlying intrinsic value.

Global long/short equity – This category has portfolios consisting of a core group of long stock positions with short sales of stock and stock indexes in global and global ex. U.S. equity markets. These managers do not attempt to be market-neutral and vary dramatically in their use of short-selling and leverage. These managers do not focus on a single sector or geographic region, instead employing a broad, global mandate.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

5. Employee Benefit Plans (continued)

Opportunistic – This category has multi-strategy portfolios which have a broad mandate and employ an opportunistic investment approach, shifting capital across asset classes and strategies depending on their profitability. These managers may vary their allocations dramatically across strategies over time and may invest heavily in a certain strategy or not at all depending on the opportunity set at that time.

The Company expects to make contributions amounting to approximately \$11,422,000 in 2011.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Year Ending June 30:	
2011	\$ 9,438,587
2012	7,637,101
2013	8,375,145
2014	9,275,556
2015	10,038,477
Years 2016–2020	63,084,002

The Company has defined contribution retirement plans (Retirement Plans) which cover substantially all employees and provides participants the ability to make pretax payroll deduction contributions for deposit into retirement savings accounts. The participants' contributions are matched at a percentage of their total contributions and up to annual dollar limits per participant as defined by the Retirement Plans. The total expense related to the above Retirement Plans was approximately \$11,576,000 in 2010 and \$10,973,000 in 2009.

6. Line and Letters of Credit

The Company has available a \$25,000,000 unsecured revolving line of credit, expiring March 1, 2011. The interest rate on the line is based on the lender's 3-month LIBOR rate plus an applicable margin. There were no outstanding draws on this facility as of June 30, 2010 and 2009.

During 2009, the Obligated Group (as defined in Note 7) of the Company entered into a letter of credit arrangement in the amount of \$90,306,740 with Union Bank, N.A. for an irrevocable, transferable, direct draw letter of credit in favor of The Bank of New York Mellon Trust Company, N.A., bond trustee, to support the payment of outstanding principal of the 2009A bonds and 49 days of accrued interest. KHF was a guarantor on the Obligated Group's letter of

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

6. Line and Letters of Credit (continued)

credit. For Tender Advances under the letter of credit, the draw rate was a fluctuating interest rate equal to the higher of Union Bank's reference rate and 2% per annum above the Federal Funds Rate in effect from time to time for 45 aggregate days and thereafter, equal to the higher of 1% per annum above Union Bank's reference rate and 3% per annum above the Federal Funds Rate in effect from time to time. There were no outstanding draws on this facility as of June 30, 2009. The letter of credit was cancelled in conjunction with the refunding of the 2009A bonds in June 2010.

During 2008, the Obligated Group of the Company entered into a letter of credit arrangement in the amount of \$50,558,905 with the Bank of Nova Scotia for an irrevocable transferable letter of credit in favor of the Bank of New York Mellon Trust Company, N.A., bond trustee, to support the payment of currently outstanding principal of the 2004B bonds and 34 days of accrued interest. The bank rate is a fluctuating interest rate per annum which for each day shall equal (a) the Alternative Base Rate, which is the higher of (i) the Scotiabank Base Rate or (ii) Federal Funds Rate plus 0.5%, plus 1.0% per annum for the 1st day through the 90th day; (b) the Alternative Base Rate plus 2.0% per annum for the 91st day through the 180th day; and (c) thereafter at the Alternative Base Rate plus 3.0%. The letter of credit expires on April 24, 2011. There were no outstanding draws on this facility as of June 30, 2010 and 2009.

As of June 30, 2010, the Company's other outstanding letters of credit were as follows:

<u>Coverage</u>	<u>Amount</u>	<u>Expiration Date</u>
Malpractice insurance policies:		
PIC	\$ 2,000,000	February 17, 2011
Workers' compensation insurance policies:		
SCH	119,000	October 30, 2011
HPH	1,000,000	February 1, 2011

There were no draws on the above letters of credit as of June 30, 2010 and 2009.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt

Long-term debt is summarized as follows:

	June 30	
	2010	2009
Series 2010A Special Purpose Revenue Bonds, interest payable semi-annually at rates ranging from 3.00% to 5.50%, principal payments in varying annual amounts ranging from \$545,000 to \$2,375,000 due July 2014 through 2021; \$335,000 to \$1,640,000 due July 2022 through 2030; \$1,280,000 to \$12,705,000 due July 2031 through 2040	\$ 98,522,814	\$ —
Series 2009A Special Purpose Revenue Variable Rate Demand Bonds, issued with a weekly interest rate determined by the Remarketing Agent and paid monthly, refunded on June 17, 2010	—	88,875,000
Series 2005A Special Purpose Revenue Bonds, interest payable semi-annually at rates ranging from 5.65% to 5.70%, refunded on July 1, 2009	—	128,089,779
Series 2005B Special Purpose Revenue Bonds, interest at 3.84%, principal and interest payable in monthly installments of \$524,873, paid in full in June 2010	—	6,169,403
Series 2004A Special Purpose Revenue Bonds, interest payable semi-annually at 5.60%, principal payments in varying annual amounts ranging from \$1,820,000 to \$3,315,000 due July 2022 through 2033	29,452,398	29,428,547
Series 2004B Insured Special Purpose Revenue Variable Rate Demand Bonds, issued in a weekly rate period and bearing interest at a weekly rate determined by the Remarketing Agent and paid monthly, principal payments in varying amounts from \$1,900,000 to \$4,200,000 due July 2015 through 2033	49,902,580	49,898,337

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt (continued)

	June 30	
	2010	2009
Series 1998 Special Purpose Revenue Bonds, interest payable semi-annually at rates ranging from 5.25% to 5.50%, principal payments in varying annual amounts ranging from \$1,125,000 to \$1,315,000 due July 2010 through 2013; \$1,200,000 to \$1,615,000 due July 2014 through 2018; \$530,000 to \$785,000 due July 2019 through 2028	\$ 16,707,848	\$ 17,772,571
Series 1993 Special Purpose Revenue Bonds, interest payable semi-annually at 6.40%, principal payments in varying annual amounts ranging from \$5,035,000 to \$6,070,000 due July 2010 through 2014	22,012,230	26,692,972
First Hawaiian Bank term loan, interest payable quarterly based on 3-month LIBOR rate plus applicable margin; principal payments due October 1 and April 1 of each year of \$5,000,000 per year; matures April 1, 2014	20,000,000	25,000,000
Total long-term debt	236,597,870	371,926,609
Less current portion	(10,969,057)	(176,771,813)
Noncurrent portion	\$ 225,628,813	\$ 195,154,796

The 2010, 2009, 2005, 2004, 1998, and 1993 Series Special Purpose Revenue Bonds are collateralized by a security interest in the gross receipts and pledged assets of the Obligated Group (comprised of HPH – parent company only, KMCWC, KMCPM, SCH and WMH) as defined in the Master Indenture. The 2010A Bonds are subject to optional redemption on or after July 2, 2020 at a redemption price equal to 100% of the principal amount being redeemed, plus accrued interest to the date of redemption, without premium. The 2010A Bonds are subject to mandatory redemption on or after July 1, 2022 payable in annual sinking fund installments from \$335,000 to \$12,705,000. The 2004A Bonds are subject to redemption on or after July 1, 2013 at a redemption price of 100% of the principal amount being redeemed, plus accrued interest to the date of redemption, without premium. The 2004A Bonds are subject to mandatory sinking fund redemption on July 1, 2022 and thereafter ranging from \$1,820,000 to \$3,315,000. The 2004B Bonds are subject to optional redemption at various terms and to mandatory redemption on or after July 1, 2015 payable in annual amounts of \$1,900,000 to \$4,200,000. The 1998 Bonds are

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt (continued)

subject to redemption on or after July 1, 2008, at redemption prices ranging from 100% to 102% of the principal amount of the bonds being redeemed. The 1998 Bonds have mandatory sinking fund requirements effective July 1, 2007 payable in amounts ranging from \$600,000 to \$1,700,000. The 1993 Bonds are subject to redemption on or after July 1, 2006, at a redemption price of 100% of the principal amount of the bonds being redeemed. The 1993 Bonds have mandatory sinking fund requirements effective July 1, 2009, payable in annual amounts ranging from \$4,730,000 to \$6,070,000.

In April 2009, the Company issued Series 2009A Bonds in the amount of \$88,875,000 to refund the Series 2005A Bonds due to the decline in the market value of the 2005 basis agreement caused by the combination of the rise of tax-exempt rates and the fall of taxable rates. The 2009A bonds were weekly resetting variable rate demand bonds that had a maturity date of July 1, 2035. As a credit enhancement to issuing the 2009A Bonds, a Non-Obligated Group member of the Company, KHF, was added as a guarantor on the Obligated Group's letter of credit supporting the repayment of these bonds. As described in Note 12, the related basis agreement was terminated on April 8, 2009 and resulted in a net loss of \$23,800,000 in the prior year.

In April 2009, the Company also executed a \$25,000,000 term loan with First Hawaiian Bank (FHB) with a maturity date of April 1, 2014. The interest rate is based on the lender's 3-month LIBOR rate plus an applicable margin (4.00% at June 30, 2010).

Proceeds from the 2009A Bonds, the FHB term loan and the balance of the 2005A Reserve Fund were deposited into an escrow trust account which were used to defease the 2005A Bonds on July 1, 2009. The escrow trust account is recorded as escrow funds held for bonds in the consolidated balance sheet as of June 30, 2009.

In June 2010, the Company issued Series 2010A Bonds in the amount of \$101,940,000 to refund the Series 2009A Bonds. The 2010A Bonds are a combination of serial bonds and term bonds. The serial bonds have maturity dates starting July 1, 2014 through 2021 and interest rates between 3.00% and 4.625%. The term bonds have maturity dates of July 1, 2030 and July 1, 2040 with fixed interest rates of 5.25% and 5.50%, respectively. A Reserve Fund was established for the 2010A Bonds of approximately \$9,729,000.

As of June 30, 2010 and 2009, \$10,458,840 and \$8,074,341, respectively, included in current assets, was held by the bond trustee to fund principal maturities and accrued interest payable.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt (continued)

Long-term debt maturities for the years succeeding June 30, 2010 are as follows. The schedule depicts the long-term debt maturities assuming the entire variable rate demand obligations for the 2004B Bonds were not remarketable as of July 1, 2010 and considering the repayment terms of the underlying letter of credit.

Year Ending June 30:	
2011	\$ 10,969,057
2012	20,709,960
2013	24,234,414
2014	24,723,676
2015	16,093,672
Thereafter	<u>139,867,091</u>
	<u>\$236,597,870</u>

Interest paid was approximately \$8,467,000 in 2010 and \$12,772,000 in 2009. Interest capitalized was approximately \$146,000 in 2009. There was no capitalized interest in 2010.

The fair value of long-term debt as of June 30, 2010 and 2009 was approximately \$239,306,000 and \$370,302,000, respectively.

The following long term debt transaction occurred after the report date but before issuance of these financial statements and is reported as a non-recognized subsequent event in accordance with FASB ASC 855. In July 2010, the Company issued Series 2010B Bonds in the amount of \$61,210,000 to refinance the \$20,000,000 Term Loan and establish a \$35,000,000 Project Fund. The 2010B Bonds are a combination of serial bonds and term bonds. The serial bonds have maturity dates starting July 1, 2014 through 2020 with an interest rate of 5.00%. The term bonds have maturity dates of July 1, 2030 and July 1, 2040 with fixed interest rates of 5.625% and 5.750% respectively. A Reserve Fund was established in July 2010 for the 2010B Bonds of approximately \$4,490,000.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

8. Other Long-Term Liabilities

Other long-term liabilities in the consolidated balance sheets consist primarily of liabilities related to HPH's and SCH's deferred compensation plans, covenant not-to-compete, capital appreciation account, other incentive compensation balances, swap liabilities (Note 12) and malpractice and ceded reinsurance reserves of approximately \$53,686,000 and \$54,450,000 as of June 30, 2010 and 2009, respectively.

In connection with the acquisition of Straub Clinic & Hospital, Inc. (SCH) by the Company in 2001, the Company is obligated to make payments on the deferred compensation and other obligations of SCHI Holdings, Inc., an unrelated for-profit corporation. While certain of the deferred compensation obligations are non-interest bearing, others bear interest at rates ranging from 2% to 10%. The deferred compensation obligations are payable at termination, retirement, or over a period of years beginning at termination or retirement of certain former employees of SCHI. The net present value of the deferred compensation obligation, at 6% interest, is approximately \$16,344,000 and \$17,778,000 as of June 30, 2010 and 2009, respectively, and is included in other long-term liabilities in the consolidated balance sheets. Total payments on the deferred compensation obligations and other obligations were approximately \$2,628,000 in 2010 and \$2,985,000 in 2009.

9. Leases

As Lessee

Leases on various types of office and storage space, office equipment and furniture are classified as operating leases.

Future minimum lease payments under noncancelable operating leases as of June 30, 2010 are as follows:

Year Ending June 30:	
2011	\$ 8,676,303
2012	6,675,353
2013	5,026,798
2014	2,772,115
2015	1,454,037
Thereafter	4,666,205
	<u>\$29,270,811</u>

Rent expense was approximately \$13,869,000 in 2010 and \$14,937,000 in 2009.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

9. Leases (continued)

As Lessor

Future minimum rental income to be received under noncancelable operating leases for office space as of June 30, 2010 is as follows:

Year Ending June 30:	
2011	\$ 1,506,491
2012	1,015,251
2013	821,948
2014	613,823
2015	377,078
Thereafter	15,968,684
	<u>\$ 20,303,275</u>

10. Income Taxes

Significant components of income tax expenses (benefit) for the taxable corporations of the Company are as follows:

	Year Ended June 30	
	2010	2009
Federal		
Current	\$ 223,325	\$ 1,471,900
Deferred	(99,461)	1,460,937
Total federal	<u>123,864</u>	<u>2,932,837</u>
State		
Current	8,268	(19,000)
Deferred	(198,395)	(841,971)
Total state	<u>(190,127)</u>	<u>(860,971)</u>
	<u>\$ (66,263)</u>	<u>\$ 2,071,866</u>

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

10. Income Taxes (continued)

Reconciliation of the federal statutory rate of 34.00% to the Company's effective income tax rate for the year ended June 30 is as follows:

	Year Ended June 30	
	2010	2009
Federal statutory rate	34.00%	34.00%
State tax rate, net of federal tax benefit	(10.17)	(4.59)
Federal valuation allowance change	–	(2.43)
Permanent items and other	(29.33)	(1.26)
Federal tax credits	–	(9.75)
Effective income tax rate	(5.50)%	15.97%

Taxes paid were approximately \$400,000 in 2010 and \$1,400,000 in 2009.

The significant components of the Company's taxable corporations deferred taxes as of June 30 are as follows:

	June 30	
	2010	2009
Deferred income tax assets:		
Tax credits	\$ 1,156,000	\$ 955,000
Net operating losses	347,000	303,000
Other	86,000	102,000
Total gross deferred income tax assets	1,589,000	1,360,000
Less valuation allowance	(303,000)	(303,000)
Net deferred income tax assets	1,286,000	1,057,000
Deferred income tax liabilities:		
Installment gain on sale of joint venture	(309,000)	(571,000)
Depreciation	(785,000)	(775,000)
Federal-tax effect of Hawaii deferred taxes	(354,000)	(286,000)
Other	(159,000)	(44,000)
Total deferred income tax liabilities	(1,607,000)	(1,676,000)
Net deferred income tax liabilities	\$ (321,000)	\$ (619,000)

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

10. Income Taxes (continued)

Deferred tax assets are included in deposits and other and deferred tax liabilities are included in other long-term liabilities in the accompanying consolidated balance sheets.

Deferred income taxes reflect the tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amount used for income tax purposes. In assessing the need for a valuation allowance, management considered all available positive and negative evidence, including past operational results and forecasted future taxable income.

The Company's taxable corporations had Hawaii net operating losses (NOL) carryforwards of approximately \$1,454,000 and \$757,000 as of June 30, 2010 and 2009, respectively, and Hawaii tax credit carryforwards of approximately \$1,156,000 and \$1,000,000 as of June 30, 2010 and 2009, respectively. The Hawaii NOL carryforwards begin to expire in 2021. The Hawaii tax credits do not expire and carryforward to future tax years until used. The deferred tax asset of \$303,000 associated with \$757,000 of the Hawaii NOL carryforwards at June 30, 2010 and 2009 are offset by a valuation allowance of \$303,000 in the consolidated balance sheets as management has determined it is more likely than not that these NOLs will not be utilized.

Some of the Company's not-for-profit organizations have generated NOLs attributable to revenue generating activities that are not related to their respective tax exempt purposes. The Company has unused Federal and Hawaii NOL carryforwards as of June 30, 2010 of approximately \$13,205,000 and \$13,205,000, respectively. The NOL carryforwards begin to expire in 2019. The deferred tax asset associated with these NOL carryforwards at June 30, 2010 and 2009 are offset by a full valuation allowance in the consolidated balance sheets as management has determined it is more likely than not that the NOLs will not be utilized.

11. Functional Classification of Expenses

The functional classification of expenses by major classes of program services and supporting activities are summarized as follows:

	Year Ended June 30	
	2010	2009
Patient services	\$ 595,149,019	\$ 560,303,473
Management and general	231,918,515	224,948,486
	<u>\$ 827,067,534</u>	<u>\$ 785,251,959</u>

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

12. Commitments and Contingencies

Workers’ Compensation Claims

The Company is self-insured for workers’ compensation claims. The Company has an outstanding letter of credit in favor of the State of Hawaii (as described in Note 6), as required by self-insurance regulations of the State of Hawaii. The Company provides its actuary with estimated claims payments and accrues workers’ compensation expense based on an actuarial determined amount. Workers’ compensation accruals totaled approximately \$4,115,000 and \$4,557,000 as of June 30, 2010 and 2009, respectively, and were recorded using a 4.49% and 5.22% discount factor as of June 30, 2010 and 2009, respectively.

In the opinion of management, adequate accruals have been provided for known and incurred but not reported workers’ compensation claims in the accompanying consolidated balance sheets.

Medical Malpractice Insurance

In June 2002, the Company formed PIC, a captive insurance company covering professional (medical malpractice) and general liability risks. PIC is a not-for-profit Hawaii domiciled pure captive whose sole corporate member is HPH. PIC operates under a Certificate of Authority from the State of Hawaii (Insurance Division) and began operations on July 1, 2002. PIC is a regulated insurance company with reserve, investment, reporting and audit requirements. The Company is covered for professional and general liability claims under a combined single limit of \$76,000,000 through PIC. The professional and general liability coverage from PIC is “claims-made”, with PIC providing tail coverage (with certain limitations) to the Company with claims-made policies prior to July 1, 2002.

For the years ending June 30, 2004 through 2010, PIC renewed its reinsurance coverages. For the years ending June 30, 2005 through 2007, PIC retained the first \$1,000,000 in risk and had reinsurance with reinsurers for total coverage of \$51,000,000. For the period July 1, 2007 to June 30, 2010, PIC retained the first \$1,000,000 in risk and had reinsurance with reinsurers for total coverage of \$76,000,000. For the first reinsurance layer of \$10,000,000, PIC entered into a “retrospective rating program”. Depending on actual claims experience, the premium is adjusted either down to a minimum of \$2,400,000 to \$3,000,000 or up to a maximum of \$6,000,000 to \$8,000,000. The amount of premiums charged by PIC to the Company’s entities was based on the expected case of \$3,600,000 to \$5,000,000 in premiums.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

12. Commitments and Contingencies (continued)

The Company estimated that it will return premiums of the following amounts and adjustments have been made to each of the Company's entities as of June 30, 2010:

<u>Period</u>	<u>Amount</u>
July 1, 2004 to June 30, 2005	\$ 501,000
July 1, 2005 to June 30, 2006	1,599,000
July 1, 2006 to June 30, 2007	1,061,000
July 1, 2007 to June 30, 2008	2,289,000
July 1, 2008 to June 30, 2009	1,896,000
July 1, 2009 to June 30, 2010	2,267,000

The Company does not have a deductible for coverages provided by PIC. PIC's total costs are allocated through a premium charge to the Company based on actuarial information derived from historical loss experience and expected losses.

Medical malpractice expense totaled approximately \$9,914,000 in 2010 and \$13,343,000 in 2009. Medical malpractice accruals totaled approximately \$47,177,000 and \$45,736,000 and reinsurance recoverables totaled approximately \$24,167,000 and \$22,021,000 as of June 30, 2010 and 2009, respectively, and were recorded using a 4.71% and 5.40% discount factor at June 30, 2010 and 2009, respectively.

Interest Rate Swap Agreements

During the second quarter of fiscal year 2004, the Company issued \$30,000,000 of fixed rate and \$50,000,000 of variable rate bonds for a total of \$80,000,000 of 2004 Bonds. In order to hedge future variability in cash flows associated with \$50,000,000 of the 2004 series variable rate debt, two tranches of floating to fixed amortizing interest rate swaps of \$25,000,000 each in notional amounts were entered into at the time the variable rate debt was issued. The Company pays fixed rates ranging between 3.842% and 3.849% and receives a variable rate tied to LIBOR. A component of the fixed rate on these two swaps include the financing of the loss on a previous, but now terminated \$30,000,000 forward starting amortizing interest rate swap on the date of termination. As of June 30, 2010 and 2009, the Company recorded an accumulated loss of approximately \$8,100,000 and \$5,500,000, respectively, in unrestricted net assets related to the current amortizing interest rate swaps outstanding. The balance of the unamortized loss as of June 30, 2010 and 2009 amounted to approximately \$1,850,000 and \$1,900,000, respectively.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

12. Commitments and Contingencies (continued)

In conjunction with the issuance of the Company's 2005A Bonds, which were issued with detachable call rights (the latter of which are held by the Company), the Company executed a 4-year swap arrangement whereby the Company received an annuity subject to adjustment based on prevailing interest rates ("basis agreement"). The swap and annuity arrangements were terminated in April 2009 and the outstanding 2005A Bonds were redeemed on July 1, 2009. Prior to termination of the swap arrangement, the Company's annuity was equal to 1.23%. The decrease in combined fair value of the swap and detachable call rights is included in loss on basis agreement in the consolidated statements of unrestricted revenues, expenses and other changes in net assets and totaled approximately \$23,773,000 in 2009.

During the fourth quarter of fiscal year 2009, management undertook a restructuring of \$128,305,000 outstanding 2005A Bonds. The Company issued \$88,875,000 of variable rate 2009A bonds and entered into a \$25,000,000 variable rate term loan with a local bank.

To hedge against future variability in cash flows in conjunction with the issuance of the 2009A variable rate bonds, the Company executed a swap arrangement with a notional amount of \$88,875,000 whereby the Company receives 68.50% of three month LIBOR and pays 2.44% fixed rate. The 2009A swap arrangement was terminated during the last quarter of fiscal year 2010 in conjunction with the refunding of the 2009A Bonds.

To hedge against future variability in cash flows in conjunction with the \$25,000,000 variable rate term loan, the Company entered into a swap arrangement with a notional amount of \$25,000,000 whereby the Company receives 68.50% of LIBOR and pays 1.505% fixed rate. The term loan swap arrangement was terminated on June 30, 2010 ahead of the planned pay-off of the term loan in July 2010.

The termination of the 2009A swap and term loan swap resulted in a net gain which is included in gain (loss) on swap arrangements in the consolidated statements of unrestricted revenues, expenses and other changes in net assets of approximately \$2,300,000 in 2010.

The mark-to-market loss on the swap arrangements related to the 2004, 2005A and 2009A Bonds was approximately \$9,931,000 and \$7,403,000 as of June 30, 2010 and 2009, respectively.

In 2007, the Company entered into a Constant Maturity Swap (CMS) arrangement whereby the Company receives 59% of 20-year LIBOR and pays 67% of one month LIBOR. During 2009, the Company opted to early terminate a portion of the CMS agreement. The remaining notional amount of the CMS arrangement, approximately \$89,152,000, was early terminated in September 2009.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

12. Commitments and Contingencies (continued)

During 2008, the Company chose to mitigate a portion of the volatility associated with its original CMS agreement entered into in 2007 by entering into another Constant Maturity Swap arrangement which is referred to as the Reverse Constant Maturity Swap (RCMS). The notional amount of \$178,300,000 for the RCMS is the same as the original CMS; however, in the RCMS arrangement, the Company pays 59% of 20-year LIBOR and receives 67% of one month LIBOR. The RCMS was also terminated in September 2009.

The CMS and the RCMS arrangements do not qualify for hedge accounting under FASB ASC 815 and the change in values is included in gain (loss) on swap arrangements in the consolidated statements of unrestricted revenues, expenses and other changes in net assets of approximately \$1,400,000 in 2010 and \$(3,187,000) in 2009.

FASB ASC 815 allows the reporting entity to offset derivative fair value and cash collateral amounts executed with the same counter-party under a master netting arrangement. The Company has chosen to adopt the netting of such amounts under its master agreement with its counterparties. The Company did not have the right to reclaim cash collateral or obligation to return cash collateral for derivatives under master netting arrangements that have not been offset against net derivative positions as of June 30, 2010 and 2009.

Certain of the Company's derivative instruments contain provisions that require an investment grade credit rating from the major credit rating agencies. If the Company's credit rating were to change or if an event of default were to occur and continue, the counterparties to the derivative instruments could demand full collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position as of June 30, 2010, is \$9,900,000 for which the Company has posted collateral of \$6,900,000 in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on June 30, 2010, the Company would be required to post an additional \$3,000,000 of collateral to its counterparty.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

12. Commitments and Contingencies (continued)

The combined tables below present the location and amounts of derivative fair values in the accompanying consolidated balance sheets and derivative gains and losses in the consolidated statements of unrestricted revenues, expenses and other changes in net assets.

Fair Values of Derivatives Instruments (in thousands of dollars)

Derivatives designated as hedging instruments under ASC 815	Asset Derivatives				Liability Derivatives			
	June 30, 2010		June 30, 2009		June 30, 2010		June 30, 2009	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts	Other noncurrent assets	\$ —	Other noncurrent assets	\$ 4,428	Other long term liabilities	\$ 9,931	Other long term liabilities	\$ 7,403
Total		\$ —		\$ 4,428		\$ 9,931		\$ 7,403

The Effect of Derivative Instruments on the Statement of Financial Performance

Derivatives in ASC 815 Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Change in Net Assets on Derivative (Effective Portion)		Amount of Gain (Loss) Reclassified from Unrestricted Net Assets into Excess of Revenues over Expenses (Effective Portion)		Amount of Gain (Loss) Recognized in Excess of Revenues over Expenses on Derivative (Ineffective Portion) and Amount Excluded from Effectiveness Testing	
	Year ended June 30		Year ended June 30		Year ended June 30	
	2010	2009	2010	2009	2010	2009
Interest rate contracts	\$(6,964,579)	\$ 1,042,871	\$ —	\$ —	\$ —	\$ —
Total	\$(6,964,579)	\$ 1,042,871	\$ —	\$ —	\$ —	\$ —

Litigation

The Company is involved in legal actions in the normal course of business, some of which seek monetary damages, including punitive damages, which are not covered by insurance. These actions, when finally concluded and determined, will not, in the opinion of management and the Company's counsel, have a material adverse effect on the Company's financial position, results of operations, or cash flows.

Other

The Company has outstanding construction commitments of approximately \$11,094,000 as of June 30, 2010.

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

13. Related Party Transactions

A joint venture investment of the Company provides laundry services to the Company. Payments for services totaled approximately \$2,675,000 in 2010 and \$2,496,000 in 2009.

A joint venture investment of the Company provides radiopharmaceuticals to the Company. Payments to the joint venture totaled approximately \$802,000 in 2010 and \$888,000 in 2009.

The Company paid approximately \$2,293,000 in 2009 for laboratory services provided by a joint venture. The Company received approximately \$113,000 in 2009 in rental income from the joint venture. The joint venture was sold in the first quarter of 2009.

As of June 30, 2010, the Company's for-profit organization had a note receivable from a joint venture of \$1,200,000. The note bears interest at 1 month LIBOR plus 2.75%. Interest only payments are due monthly for the first 24 months, and thereafter principal and interest payments are due monthly. Interest earned on the note was \$17,000 in 2010. The Company's for-profit organization also is guarantor on the joint venture's seven year note payable to a bank due in March 2017 in the amount of \$3,506,534 as of June 30, 2010. The Company's for-profit organization is fully liable on the note in the event of non-performance by the joint venture. As of June 30, 2010, the fair value of the guarantee liability is approximately \$628,000 based on the likelihood of non-performance and is included in accrued expenses in the accompanying consolidated balance sheets.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

13. Related Party Transactions (continued)

SCH leased land from the Hawaii Pacific Health Retirement Plan (Straub Clinic & Hospital Defined Benefit Pension Plan prior to merger into the Hawaii Pacific Health Retirement Plan on December 31, 2005) for \$696,000 in lease rent for both 2010 and 2009. The lease terminates in 2042 and rental payments are renegotiated every five years based on appraisal of the underlying land. Based upon the most recent appraisal, future annual lease payments are \$696,000 through 2011. The Office of Pension and Welfare Benefit Programs granted the Straub Clinic & Hospital Defined Benefit Pension Plan an exemption from prohibitions for the aforementioned lease arrangement. As of June 30, 2010, future minimum lease payments under this lease agreement are as follows:

Year Ending June 30:	
2011	\$ 696,000
2012	696,000
2013	696,000
2014	696,000
2015	696,000
Thereafter	18,444,000
	<u>\$ 21,924,000</u>

14. Restricted Net Assets

Temporarily restricted net assets are summarized as follows:

	June 30	
	2010	2009
Health and hospital care	\$ 6,330,494	\$ 10,439,982
Plant expansion and equipment replacement	8,607,453	1,253,456
Research and grants	2,979,043	1,953,005
Education and scholarships	729,131	765,729
	<u>\$ 18,646,121</u>	<u>\$ 14,412,172</u>

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

14. Restricted Net Assets (continued)

Permanently restricted net assets are summarized as follows:

	June 30	
	2010	2009
Health and hospital care	\$ 8,374,895	\$ 7,963,772
Research and grants	3,256,485	3,093,062
	<u>\$11,631,380</u>	<u>\$11,056,834</u>

15. Endowment

The Company's endowment consists of approximately 41 individual funds established for a variety of purposes. The endowment includes both donor-restricted funds and funds designated by the Board of Directors to function as endowments. Net assets associated with the endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Interpretation of Relevant Law

In June 2009, Hawai'i Revised Statute 517E was signed into law, enacting UPMIFA. UPMIFA became effective on July 1, 2009, replacing the Uniform Management of Institutional Funds Act. UPMIFA applies to institutional funds created after July 1, 2009 and to decisions made after July 1, 2009 for existing institutional funds. UPMIFA eliminates the concept of "historic dollar value" and allows an institution to spend or accumulate as the board determines is prudent for the uses, benefits, purposes and duration of the endowment fund unless the gift instrument states a particular rate or formula.

The Company's Board of Directors has interpreted UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Company classifies as permanently restricted net assets (1) the original value of gifts donated to the permanent endowment, (2) the original value of subsequent gifts to the permanent endowment and (3) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is characterized as temporarily restricted net assets until those amounts are appropriated for expenditure by the Company in a manner consistent with the standard for

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

15. Endowment (continued)

expenditure prescribed by UPMIFA. In accordance with UPMIFA, the Company considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. The duration and preservation of the fund.
2. The general purposes of the Company and the donor-restricted endowment fund.
3. General economic conditions.
4. The possible effect of inflation and deflation.
5. The expected total return from income and the appreciation of investments.
6. Other resources of the Company.
7. The investment policies of the Company.

Funds with Deficiencies

From time-to-time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires the Company to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature that are reported in unrestricted net assets were \$300,782 and \$337,648 as of June 30, 2010 and 2009, respectively.

Return Objectives and Risk Parameters

The Company has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity. Under this policy the endowment assets are invested in a manner that is intended to produce results that equal or exceed a mix of the Russell 3000, MSCI All Country World, consumer price index plus 5%, Hedge Fund Research, Inc., and Barclays Capital benchmarks. The Company expects its endowment funds to provide an annual real return, net of inflation and management fees, of approximately 5% over long time periods. Actual returns in any given year may vary from this amount.

Hawai‘i Pacific Health

Notes to Consolidated Financial Statements (continued)

15. Endowment (continued)

Strategies Employed for Achieving Objectives

To satisfy its long-term rate-of-return objectives, the Company relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Company targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

Spending Policy and How the Investment Objectives Relate to Spending Policy

The Company has a policy of appropriating for distribution each year 4.5% of its endowment fund’s average fair value using quarter end values for the preceding three years. The amount of the distribution is subject to a 6% cap and 3% floor applied to the most recent quarter end value to account for market volatility. In establishing this policy, the Company considered the long-term expected return on its endowment. Accordingly, the Company expects the current spending policy to allow its endowment to grow over long time periods. This is consistent with the Company’s objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment returns.

The endowment net asset composition by type of fund consists of the following at June 30:

		June 30, 2010			
		Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds		\$ (300,782)	\$ 2,619,348	\$ 11,631,380	\$ 13,949,946
Board-designated funds		175,145,779	–	–	175,145,779
		\$ 174,844,997	\$ 2,619,348	\$ 11,631,380	\$ 189,095,725
		June 30, 2009			
		Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds		\$ (337,648)	\$ 2,163,924	\$ 11,056,834	\$ 12,883,110
Board-designated funds		160,155,647	–	–	160,155,647
		\$ 159,817,999	\$ 2,163,924	\$ 11,056,834	\$ 173,038,757

Hawai'i Pacific Health

Notes to Consolidated Financial Statements (continued)

15. Endowment (continued)

Changes in endowment net assets for the year ended June 30 consists of the following:

	Year Ended June 30, 2010			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 159,817,999	\$ 2,163,924	\$ 11,056,834	\$ 173,038,757
Investment income:				
Investment income	3,048,278	200,752	147,406	3,396,436
Net appreciation (realized and unrealized)	12,013,520	338,146	263,716	12,615,382
Total investment income	15,061,798	538,898	411,122	16,011,818
Contributions	–	2,000	163,424	165,424
Appropriation of endowment assets for expenditure	(34,800)	(321,039)	–	(355,839)
Transfers	–	235,565	–	235,565
Endowment net assets, end of year	<u>\$ 174,844,997</u>	<u>\$ 2,619,348</u>	<u>\$ 11,631,380</u>	<u>\$ 189,095,725</u>
	Year Ended June 30, 2009			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 193,574,301	\$ 3,397,207	\$ 9,561,299	\$ 206,532,807
Investment income (loss):				
Investment income (loss)	4,079,688	191,450	(399,718)	3,871,420
Net depreciation (realized and unrealized)	(37,835,990)	(1,303,983)	–	(39,139,973)
Total investment loss	(33,756,302)	(1,112,533)	(399,718)	(35,268,553)
Contributions	–	–	1,908,153	1,908,153
Appropriation of endowment assets for expenditure	–	(133,650)	–	(133,650)
Transfers	–	12,900	(12,900)	–
Endowment net assets, end of year	<u>\$ 159,817,999</u>	<u>\$ 2,163,924</u>	<u>\$ 11,056,834</u>	<u>\$ 173,038,757</u>

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