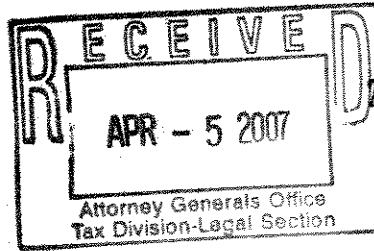


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FIRST CIRCUIT COURT
STATE OF HAWAII
FILED

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CLERK

Master for the 120th Annual Account

IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In the Matter of the Estate

of

BERNICE P. BISHOP,

Deceased.

) EQUITY NO. 2048
)
) MASTER'S REPORT FOR THE
) 120TH ANNUAL ACCOUNT OF THE
) TRUSTEES; CERTIFICATE OF
) SERVICE
)
) Hearing:
) Date: April 20, 2007
) Time: 10:00 a.m.
) Judge: Colleen K. Hirai
)
)

MASTER'S REPORT FOR THE
120TH ANNUAL ACCOUNT OF THE TRUSTEES

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IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In the Matter of the Estate) EQUITY NO. 2048
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 of) MASTER'S REPORT FOR THE
) 120TH ANNUAL ACCOUNT OF THE
BERNICE P. BISHOP,) TRUSTEES; CERTIFICATE OF
) SERVICE
)
 Deceased.) Hearing:
) Date: April 20, 2007
) Time: 10:00 a.m.
) Judge: Colleen K. Hirai
)
_____)

MASTER'S REPORT FOR THE
120TH ANNUAL ACCOUNT OF THE TRUSTEES

TO THE HONORABLE PRESIDING JUDGE OF THE ABOVE-ENTITLED COURT:

Comes now DAVID L. FAIRBANKS, the duly appointed
Master ("Master"), having completed his review of the Trustees'
Petition of the One Hundred Twentieth Annual Account and
examination of Exhibits "A"-"H"¹ (the "Petition") filed by the
Trustees under the Will and of the Estate of Bernice Pauahi
Bishop, Deceased ("Trust Estate", "Kamehameha Schools" or "KS")
on May 12, 2006, supplemented on June 6, 2006² and August 31,

¹ Exhibits "E" (Federal Form 990), "F" (Report of Education Group), "I" (Receipts and Disbursements) and "J" (Summary of Receipts and Disbursements by Income Statement Categories) were blank and labeled "To Be Filed When Available."

² See First Supplement to Trustees' Petition for Approval of the One Hundred Twentieth Annual Account (FYE June 30, 2005), attaching Exhibits "E", "I" and "J".

2006,³ review and examination of other supplemental materials provided to the Master by the Trustees, and having conducted such additional interviews, investigations and inquiries deemed to be relevant and appropriate, respectfully reports to the Court as follows:

I

INTRODUCTION

A. The Petition.

The Petition was filed by ROBERT KALANI UICHI KIHUNE (Chair of the Board of Trustees), JAMES DOUGLAS KEAUAU ING, CONSTANCE HEE LAU, DIANE JOYCE PLOTTS and CHARLES NAINOA THOMPSON ("Trustees" or "Petitioners"). Petitioners are the duly appointed, qualified and acting Trustees under the Will of Bernice Pauahi Bishop, Deceased, who died on October 16, 1884, and whose Will and two codicils (collectively the "Will") were duly admitted to Probate in the Supreme Court of the Hawaiian Islands on December 2, 1884.⁴

³ See Second Supplement to Trustees' Petition for Approval of the One Hundred Twentieth Annual Account (FYE June 30, 2005) ("Second Supplement"), attaching Exhibit "F".

⁴ See Decree Regarding Selection of Trustees entered on November 22, 2000, and the Vesting Order entered on December 11, 2000 (Vesting James Douglas Keauhou Ing, Robert Kalani Uichi Kihune, Constance Hee Lau, Diane Joyce Plotts, and Charles Nainoa Thompson); Order Granting Petition for Reappointment of Trustee, filed on September 4, 2001, reappointing Diane Joyce Plotts as Trustee for the term commencing January 1, 2002 and terminating on June 30, 2006; Order Granting Petition for Reappointment of Trustee Filed June 23, 2002, filed on December 3, 2002, reappointing James Douglas Keauhou Ing as Trustee for the term commencing January 2, 2004 and terminating on June 30, 2007; and Order Granting Petition for Reappointment of Trustee Filed June 28, 2004 filed on August 8, 2004 reappointing Robert Kalani Uichi Kihune as

B. The Purpose of the Trust Estate.

The Trust Estate exists solely for the support of Kamehameha Schools and the educational purposes set forth in the Will.

C. Appointment of the Master.

Your Master was duly appointed pursuant to that Order of Reference to Master filed on May 24, 2006 ("Order of Reference"), to examine and report upon the Petition which covers the 120th Annual Account period of the Trust Estate, beginning July 1, 2004 and ending June 30, 2005 (the "Account Period").

D. The New Guidelines.

This is the first Master's Report for the Annual Account of the Trustees pursuant to the Amended Guidelines (also called "New Guidelines") concerning the Court-appointed Master's review of the Annual Account of the Trustees of the Estate of Bernice Pauahi Bishop. As the Court is aware, the Amended or New Guidelines were the result of the combined efforts of prior

Trustee for the term commencing January 1, 2004, and terminating on June 30, 2008; Amended Order Granting Petition for Reappointment of Trustee Filed June 28, 2004 filed on October 13, 2004 reappointing Robert Kalani Uichi Kihune as Trustee for the term commencing January 1, 2005, and terminating on June 30, 2009; Order Granting Petition for Reappointment of Trustees Filed on June 15, 2005, filed on August 10, 2005, reappointing Charles Nainoa Thompson as Trustee for the term commencing on January 1, 2006 and terminating on June 30, 2010; Order Granting Petition for Reappointment of Trustee Filed on December 29, 2005, filed March 2, 2006, reappointing Diane Joyce Plotts as Trustee for the term commencing July 1, 2006 and terminating on June 30, 2011; and Order Granting Petition for Reappointment of Trustee Filed on December 11, 2006, filed March 6, 2007, reappointing James Douglas Keauhou Ing as Trustee for the term commencing July 1, 2007 and terminating on June 30, 2012.

Court-appointed Masters Colbert M. Matsumoto (109th - 111th Annual Accounts), Benjamin M. Matsubara (112th - 117th Annual Accounts) and David L. Fairbanks (118th - 120th Annual Accounts), the Attorney General of the State of Hawaii, as *parens patriae*, through Deputy Attorney General Hugh R. Jones, and the Trustees of the Trust Estate. The process of review, drafting and discussions concerning the proposed New Guidelines culminated in a Stipulation Concerning Revisions to Amended Guidelines ("Stipulation") and Order filed January 6, 2006. The New Guidelines were attached as Exhibit "A". Pursuant to the Stipulation approved and ordered by the Court, the New Guidelines were effective "commencing with the review of the Trustees' 120th Annual Accounts (fiscal year end June 30, 2005)." ⁵

Over several years, many stipulations, court orders and various amendments to reporting requirements have been entered into, issued, and made with respect to the Master's review of the Trustees' Annual Accounts.⁶ The purposes of the New Guidelines are to: (1) consolidate, eliminate and modify the previous stipulations, court orders and amendments; and (2) "create guidelines that simplify the reporting process . . ."⁷ While the New Guidelines are designed to "assist" the

⁵ See Stipulation at 4.

⁶ See Stipulation, Exhibit A, at 1-2.

⁷ Id. at 2.

Court-appointed Master "in the review of the Trusts' annual accounts," they clearly state that "the master will not be limited to . . . the information required to be reported pursuant to the guidelines." Rather, the Master "may inspect such other information and records as necessary."⁸ Nor is the Master constrained in any way by the New Guidelines in reviewing or reporting to the Court on any matter concerning the Annual Accounts on the subject fiscal year.

Nothing in these New Guidelines shall be deemed or construed to preclude the Master from reviewing and reporting to the Court on any matters concerning the Accounts or the subject fiscal year.⁹

The Stipulation expressly states that it:

. . . supercedes the 1995 Stipulation, 1998 Stipulation and the 2000 Stipulation, and any and all prior orders concerning the form and content of the Trustees' annual accounts. However, the Order Granting in Part and Denying in Part Petition for Instructions Construing Provisions of the 1997 Stipulations and Related Issues filed herein on August 11, 2000 shall continue to apply to the interpretation of those legal opinions concerning the Trustees' fiduciary responsibilities as Trustees under the New Guidelines.¹⁰

In addition, the Stipulation states that nothing in it:

. . . shall be deemed or construed to preclude, estop or otherwise bar any interested party from seeking other or further relief from the court in this

⁸ Id. at 4.

⁹ Id., Section III, F.

¹⁰ Id. at 5.

proceeding or upon any parties' response
or objection now pending or filed herein-
after¹¹

E. Organization and Format of Master's Report.

For several of the more recent Master's Reports on the Trustees' Annual Accounts, the format and organization of the reports have basically followed the prior Stipulations, Court Orders and Amended Guidelines.¹² This made the Master's Report somewhat more difficult to follow. With the adoption of the New Guidelines, your Master's Report for the 120th Annual Account will be modified and organized into seven basic parts or sections: (1) Introduction; (2) Summary of Significant Events; (3) Asset Management; (4) Fulfillment of the Educational Mission; (5) Administration of the CEO-Based Management System; (6) Master's Recommendations; and (7) Conclusion. It is anticipated that future Master's reports for the Annual Accounts will basically follow this more simplified organization and format.

F. Timing of Filing Petition for Approval and Filing of Master's Report.

As the Court is aware, there has been a considerable time gap between the filing of a Petition for Approval of the Annual Accounts of the Trustees and the hearing on, and resolution of, the Petition. Consequently, there is a correspondingly

¹¹ Id. at 5.

¹² See, e.g., Master's Reports for the 117th, 118th and 119th Annual Accounts of the Trustees.

wide gap between the fiscal year under review and the current fiscal year. Some time gap is unavoidable. However, the time gap became more extended as a result of the turmoil and well-reported events involving the Trust Estate in the late 1990s, the change in the organization and method of management, and the transition to the CEO-based system of management. The demands upon the Trustees, and even more so on Executive Management, to organize and implement the new management system and at the same time continue to operate the Trust Estate to support and fulfill its mission were considerable. Added to these demands were the requests for information, documents and reports made by the Court-appointed Masters in order to complete their review of the Annual Accounts and report to the Court. Delays were unavoidable.

Your Master, the Trustees, and Executive Management have been working to reduce that time gap. The maturing of the CEO-Based Management System has been the most prominent development that provides the potential for substantially reducing the gap. It is anticipated that the New Guidelines will also facilitate reducing the gap by simplifying the form and content of the information initially provided to the Master and the Attorney General by the Trust Estate. Your Master anticipates and intends that the Report for the 120th Annual Account and the Petition for Approval of the 121st Annual Account

and the corresponding Master's Report will be completed within calendar year 2007. Thereafter, the filing of the Petition and the Master's Reports to this Court should be on a more regular schedule and have a substantially smaller time gap between the fiscal year under review and the current year. To that end, your Master's Report for the 120th Annual Account may not contain as much detail as prior reports, but this should not be construed as a lack of careful review by your Master and his financial consultant.

G. Review Process.

Pursuant to the Order of Reference, your Master and the Master's financial consultant, Horwath Kam & Company, have attended various Trustee meetings, met with the Trustees, the Chief Executive Officer ("CEO"), various members of the Executive Management Team and staff, the headmasters of the three Kamehameha Schools campuses, Director of Internal Audit, and conducted such interviews, discussions, inquiries, reviews and investigations which they deemed appropriate. In addition, your Master and his financial consultant have reviewed the following records and documents provided by the Trust Estate:

- a. The Petition and all attached Exhibits;
- b. The Will;
- c. Selected previous Master's Reports filed with the Court;

- d. Kamehameha Schools Annual Report, July 1, 2004 - June 30, 2005 (the "Annual Report");
- e. Selected prior Annual Reports;
- f. Kamehameha Schools' and Subsidiaries' Consolidated Financial Statements and Supplemental Schedules (June 30, 2005, 2004, 2003 and 2001);
- g. Closing Agreement Monitoring Reports for previous years;
- h. Reports, documents and records provided by the Trust Estate; and
- i. 120th Annual Account: Report to Master & Attorney General, Volumes 1 and 2.

H. Reporting of Events Occurring After the Account Period.

As in the past, the Trustees, from time to time, have invited the Master and his financial consultant to attend meetings (including meetings of the Audit Committee), and generally kept the Master informed of current developments affecting the Trust Estate through reports, correspondence and telephone conferences. In addition, your Master has been provided copies of reports prepared by the KS Internal Auditor ("IA").

From time to time, this Report may refer to events or matters occurring after the Account Period where relevant to

the Account Period or where otherwise required or deemed appropriate.

II

SUMMARY OF SIGNIFICANT EVENTS

KS has reported the following significant events for the Account Period.

A. Financial and Education.

1. Total Revenues and Expenses.

The KS Consolidated Statements of Activities for the Account Period reported "Total revenues, gains and other support" of approximately \$837,181,000 compared with "Total expenses" of approximately \$312,642,000, resulting in an increase in net assets of approximately \$524,539,000 over FY 2003-2004.

2. Capital Expenditures.

Capital expenditures were approximately \$36,995,000 for the Account Period compared with approximately \$90,618,000 for FY 2003-2004 and \$127,176,000 for FY 2002-2003.

3. Return on Endowment Fund.

KS reported an overall 12.9% return on its Endowment Fund for this Account Period, compared with 15.4% for FY 2003-2004. KS investments have performed well in comparison to KS' Blended Portfolio Benchmark and KS' Long-Term Target, CPI+5%. The performance is comparable to the Cambridge Associates' Large

Endowment Fund Median of 13% (KS' Peer Group benchmark). For a more detailed discussion, see Section C.1., infra.

4. Educational Spending.

Annual KS spending for educational purposes in FY 2004-2005 totaled approximately \$222,458,000. This was an increase of approximately \$1,900,000 from FY 2003-2004, and constitutes a spending rate of 4.0% of the five (5) year average market value of the KS endowment. This amount includes monies allocated to the three KS campuses (Kapalama, Maui and Hawaii), preschools (31), and Community Outreach Education preschools (31), Charter Schools¹³ and Early Childhood Education, Extension Education and Virtual Strategies/Distance Learning.

5. New Education Strategic Plan.

In June, 2005 the KS Trustees approved a new Education Strategic Plan.¹⁴ In general, the Educational Strategic Plan targets and gives greater priority to early childhood education (birth to eight years of age) in communities that are predominantly Hawaiian and calls for the dedication of greater resources and funds to these programs. The plan sets goals for reaching certain numbers of children by milestone dates. As pointed out in your Master's Report for the 119th Annual Account,

¹³ KS provided more than \$3.15 million in support of the charter schools and charter conversion schools during the Account Period. See Second Supplement, Exhibit "F", Annual Education Report of the Kamehameha Schools 2004-2005 at 22.

¹⁴ For a more detailed discussion of the Educational Strategic Plan, see Section IV, A., infra.

the expansion of KS outreach to more members of the Hawaiian community and the targeting of younger children are laudable. However, the use of mere numbers of people or students "reached" or "served" is not the sole measure of the success of the various programs¹⁵ or justification for the existence of a specific program. Developing methods to accurately measure or evaluate the success of these outreach and early education programs is critical to the evaluation, continuation or modification of such programs. They must be closely monitored.

6. Students at KS.

For School Year 2004-2005, the combined enrollment at the three KS campuses was 5,132 students for grades K-12. This was an increase of 278 students from School Year 2003-2004. The increase was primarily due to the addition of Grade 11 at both the Maui and Hawaii campuses.¹⁶

By the end of the 2004-2005 School Year, pre-school enrollment totaled 1,439 students, an increase of 42 students over the previous year.¹⁷

¹⁵ See Master's Report for 119th Annual Account at 7-8.

¹⁶ Summer school programs included a total of approximately 2,100 non-KS students at the three campuses. See Exhibit "F" to Petition at 3.

¹⁷ However, it should be noted that during SY 2004-2005 KS closed two sites. Id. at 25.

In addition, KS reported that more than 3,200 children under the age of eight were served by the combined pre-school and Early Childhood Education programs ("ECE").¹⁸

a. Kapalama Campus.

Enrollment at the Kapalama Campus remained stable (actually there were two (2) fewer students than in the previous year). Ninety-six percent (96%) of the graduating class pursued higher education. During the 2004-2005 School Year, the high school attained Western Association of Schools and Colleges ("WASC") accreditation for a six (6) year period and the middle school began the WASC accreditation process with the required self-study.

In addition, several (16) major repair and capital improvement projects were completed at a total cost of \$11,570,083.¹⁹

b. Maui Campus.

In school year 2004-2005, enrollment increased by 141 students (to a total of 967). The increase is the result of the addition of Grade 11. The 2005-2006 K-12 enrollment goal is 1,120 students. In addition, the Maui Campus separated the Middle School and High School.

¹⁸ Id. at 3.

¹⁹ Id. at 8.

The high school completed its self-study as part of the WASC accreditation process. The on-site visit by the WASC accreditation team will occur during School Year 2005-2006.

The principal of the high school retired for medical reasons and a new principal was hired.

Three additional high school buildings were completed or near completion during the School Year. Completion of three (3) additional buildings for the high school, originally anticipated for completion during School Year 2004-2005, was extended to School Year 2005-2006.

c. Hawaii Campus.

Like the Maui Campus, the increase in enrollment for School Year 2004-2005 (from 830 to 970) was due to the addition of the 11th Grade. It is anticipated that the enrollment plan for KS Hawaii will be completed in School Year 2005-2006 when enrollment will reach the K-12 goal of 1,120 students.

The WASC accreditation process proceeded with the required self-study and was scheduled for completion in the Fall of 2005. The visit of the outside accreditation team is scheduled for Spring, 2006.

During School Year 2004-2005, KS Hawaii embarked upon the initial stages of developing collaboration efforts with

the Department of Education and Queen Lilioukalani Children's Center.

Construction for the high school campus was completed during the School Year with the completion of the administration building, career academy building, music building, and the swimming pool.

7. Early Childhood Education ("ECE") and Outreach Programs.

Pursuant to the new Educational Strategic Plan, KS continued to develop and expand its ECE and Outreach Programs. Your Master supports KS' efforts in this regard. However, close monitoring and developing accurate methods to measure the success of these programs and services are required. KS indicates that, in general, seven key factors will be utilized to measure the success or value of programs and services: (1) school readiness; (2) growth/achievement; (3) literacy; (4) graduation/promotion; (5) family involvement; (6) cultural knowledge and practice; and (7) leadership and community giveback.²⁰ These are rather broad concepts or indicators and each may be subject to multiple, varying interpretations.

²⁰ See 120th Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "C" (The KS Education Strategic Plan, June 1, 2005) at 28.

B. Executive Management and Structure.

1. General.

During the Account Period, the KS Executive Management Team continued to: refine its organization and functions; develop better and more efficient functioning within each group; and develop better coordination and cooperation with the other groups of the Team. The significant changes in the Executive Management Team, such as VP of Strategic Planning & Implementation and VP of Campus Strategies were noted in your Master's Report for the 119th Annual Account. In addition, in May, 2005, Ann Botticelli was appointed VP for Community Relations and Communications. The position of VP for Education remained unfilled.²¹

Julian Ako, Interim Head of Educational Support Services, became Principal of the High School at the Kapalama Campus upon the retirement of long-time principal, Tony Ramos. Sylvia Hussey was named Head of Educational Support Services.

2. Community Outreach Education.

KS established a new Community Outreach Division or function which reports directly to the CEO. Included in this division, or function, are: Early Child Education, Extension Education, Virtual Campus and Land Legacy Education.

²¹ The position remains vacant today. The headmasters of the three campuses report directly to the CEO.

3. Educational Support Services ("ESS") Division.

A new division was created: Educational Support Services. As mentioned above, Sylvia Hussey was named Head of ESS. The Office of Admissions, Educational Technology Services and the KS Press were also placed in the ESS Division.

4. Financial Aid and the Ho`oulu Hawaiian Data Center.

In another change in organization, Financial Aid was merged with the Ho`oulu Hawaiian Data Center and placed within the KS Finance and Administration Division.

5. Communications and Community Relations Division.

A new division was created for Communications and Community Relations headed by a Vice President (Ann Botticelli) who reports directly to the CEO. This division includes Community Liaison, Legislative Liaison and Neighbor Island Regional Resource Centers.

These changes are not major shifts in organization. Rather, they are more in the nature of adjustments or refinements to promote improved operational efficiencies and communications between the Executive Management Team and the CEO. Aside from the above, there have been very few changes in the Executive Management Team, and it appears to be reasonably stable. Your Master is generally pleased with the progress and improvement in the efficiency, cooperation and coordination of the KS Executive Management Team.

C. Other Significant Events.

1. John Doe v. Kamehameha Schools, et al.

Although occurring outside the Account Period, the recent decision of the Ninth Circuit Court of Appeals in the lawsuit challenging the Kamehameha Schools admissions policy, John Doe v. Kamehameha Schools, et al., Civil No. 03-00316 (D. Hawaii 2003), is a most significant event which should be noted. As this Court is aware, the Ninth Circuit had reversed the favorable decision of the Hawaii District Court.²² However the Ninth Circuit agreed to re-hear the appeal en banc.²³ Oral argument was held on June 20, 2006 and on December 5, 2006 the Ninth Circuit reversed the decision of the three-judge panel that initially had heard the appeal, thus affirming the favorable decision in 2003 by the Hawaii District Court.²⁴ The plaintiff is seeking certiorari to the United States Supreme Court. The continued uncertainty surrounding this critical issue necessarily has some impact upon the development of policies and their implementation with respect to admissions, operating costs and tuition at the three campuses.

²² See 416 F.3d 1025 (9th Cir. 2005).

²³ See 441 F.2d 1029 (9th Cir. 2006).

²⁴ See John Doe v. Kamehameha Schools, et al., 470 F.3d. 827 (9th Cir. 2006) (en banc).

2. Expiration of the Internal Revenue Service ("IRS") Closing Agreement.

Pursuant to the Closing Agreement dated February 23, 2000 between the IRS and Kamehameha Schools, KS was required to file reports concerning its compliance with the provisions of the agreement for a period of five (5) years.²⁵ The five (5) year period expired during the Account Period (February 23, 2005). Your Master notes that during that period there have been no objections, criticisms or inquiries raised by the IRS with respect to KS' compliance with the Closing Agreement or with respect to the reports filed with the IRS by KS' Internal Auditor.

One of the most significant provisions of the Closing Agreement mandated the organization and implementation of a CEO-Based Management System at KS.²⁶ While the terms contained in the Closing Agreement have expired, the KS Trustees remain steadfastly committed to the CEO-Based Management System, as well to the other important provisions in the agreement.

²⁵ Under the Closing Agreement, the Director of Internal Audit at KS was charged with monitoring KS' compliance with the Agreement and preparing and filing the reports with the IRS. See Closing Agreement, Part A.1.O. (February 23, 2000).

²⁶ Id. at Part A.1.F. The Closing Agreement included many other subjects, including the Role of Trustees, Suspension or Removal of Trustees, Conflict of Interest Policy, Comprehensive Educational Plan and Strategic Plan and Investment Policy and Investment Performance Reports.

III

ASSET MANAGEMENT

A. Overview.

The initial scope and process of the Master's review, analysis and assessment of the Trustees' management of the Trust Estate's assets during the Account Period is set forth in the New Guidelines and the actual process followed is outlined in Section I.G. of this Report.

The standards utilized by the Master and his financial consultant in reviewing, analyzing and assessing the Trustees' management of the Trust assets are based upon the terms of the Will of Bernice Pauahi Bishop, deceased, applicable law and "best practices" adopted by Kamehameha Schools. Specific terms of the Princess Pauahi's Will and applicable law include, but are not limited to:

1. Financial Accountability.

Princess Pauahi, no doubt, had great confidence and trust in the business abilities of those she named as Trustees in her Will. However, she recognized that because her Trustees would be managing property they did not personally own, she specified that they be accountable to the Court regarding the financial condition of the Trust Estate and the management of its assets. It is, therefore, incumbent upon the Trustees, in submitting their annual account, to provide relevant and

meaningful financial information to facilitate the Court's review. More specifically, the financial statements and supplemental schedules, tax returns, IA reports, actual-to-budget financial statements, performance accounting schedules and reports, and other reports must provide sufficient information to evaluate the Trustees' performance of Kamehameha Schools.²⁷

2. Management of the Trust Assets.

In establishing the Trust Estate, Princess Pauahi bequeathed all of her residual estate to her designated Trustees to hold in trust to: (1) establish the Kamehameha Schools; (2) invest the assets; and (3) generate sufficient annual income to maintain the schools and devote a portion of each year's income to the support and education of orphans, and others in indigent circumstances, giving preference to Native Hawaiians.

In the First Codicil to her Will, Princess Pauahi empowered her Trustees to: (1) sell and dispose of any lands or other portion of her estate; (2) exchange lands and otherwise dispose of them; (3) purchase land and take leases of land whenever the Trustees think it expedient; and (4) generally make such investments they consider best. However, she cautioned the

²⁷ See Chapter 10, ALI-ABA's Fiduciary Accounting Guide, 2nd Ed. (1998), Robert Whitman, Professor of Law, University of Connecticut School of Law; and How to Assess Nonprofit Financial Performance, (2001), Elizabeth Keating, Assistant Professor of Accounting & Information System, Kellogg Graduate School of Management, Northwestern University and Peter Frumkin, Assistant Professor of Public Policy, Kennedy School of Government, Harvard University.

Trustees not to sell any real estate, cattle ranches, or other property, but continue to manage them, unless, in their opinion, a sale may be necessary for the establishment or maintenance of the schools, or in the best interests of the Estate.

3. Evaluating the Investment Portfolio.

Princess Pauahi not only required that her Trustees account for all receipts and expenditures, but specifically required an annual review of their investments. Thus, her Will requires that the Trustees annually file with the Court "an inventory of the property in their hands and how invested." In addition, she directed that the inventory of investments be published in a newspaper for public review. The language of the Will clearly reveals her belief that maintaining the integrity of her Trust Estate's holdings and operations required annual judicial scrutiny, and even public review.

4. Make Assets Productive.

A trustee is under a general duty to hold, manage, and invest trust property so that the trust estate can produce a reasonable return appropriate to the particular trust's purposes, requirements and circumstances.²⁸

²⁸ See Ahuna v. Dept. of Hawaiian Home Lands, 64 Haw. 327, 640 P.2d 1161 (1982); Duty to Make the Trust Property Productive, Restatement (Second) of Trusts, Section 181 (1959); and HRS, Section 554C-4.

5. The Prudent Investor Standard.

The Trustees of Kamehameha Schools are expected to invest the Trust assets in a manner which will produce income to attain the Trust's objectives. In discharging their investment obligation, the Trustees are required to deal with Trust assets in accordance with the so-called "Prudent Investor" Standard. HRS, Section 554C-1 (Uniform Prudent Investor Act) provides that:

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this chapter. (b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust....

The Will and its Codicils do not restrict, eliminate or alter the provisions of HRS, Section 554C-1(a).

HRS, Section 554C-2 describes the Prudent Investor Standard:

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.²⁹

²⁹ See also, HRS, Section 554C-2(c) which sets forth the considerations that a trustee must take into account when investing and managing trust assets.

Consequently, KS Trustees must comply with the Prudent Investor Standard as set forth and described in HRS, Section 554C-1-2.

6. Prudent Investment Requires a Strategic Plan.

Evaluation of the investment performance of the Trust Estate cannot be fairly achieved by merely examining the results from one year's investment, since it represents only a single snapshot of an investment continuum. Rather, investment results must be evaluated from a broader perspective. That requires that the investment performance be measured against the overall strategy of the Trust Estate: both as to investments and the achievement of Trust objectives. Accordingly, the Prudent Investor Standard requires the exercise of reasonable care, skill, and caution, and is applied to investments not in isolation but in the context of the Trust portfolio, and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the Trust.³⁰

7. Diversification of Investments.

To mitigate risk, a trustee has a duty to diversify the trust investment portfolio. HRS Section 554C-3 provides that:

³⁰ See HRS, Section 554C-2(b) which essentially requires establishing a strategic plan.

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances or directives of the trust, the purposes of the trust are better served without diversifying.

8. Management of Costs.

A trustee also has an obligation to manage the costs of the trust to ensure that such costs are appropriate and reasonable. HRS, Section 554C-7, states that:

[I]n investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

9. Delegation of Investment and Management Functions.

While a trustee has the authority to delegate investment and management functions, the trustee must exercise care, skill and caution. HRS, Section 554C-9 provides that:

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in: (1) Selecting an agent; (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

B. Financial Accountability.

1. Consolidated Financial Statements and Supplemental Schedules for the Fiscal Years Ending June 30, 2005 and 2004.

The consolidated financial statements were audited in accordance with generally-accepted auditing standards in the United States by KPMG, LLP. In an unqualified independent auditors' report dated September 16, 2005, KMPG, LLP opined that: (1) in all material respects, the consolidated financial statements present fairly the financial position of Kamehameha Schools and its subsidiaries as of June 30, 2005 and 2004; and (2) the changes in KS' net assets and cash flows for those fiscal years were in conformity with the generally-accepted accounting principles in the United States.

Significant highlights for the fiscal years ending June 30th are listed below:

Account	2005	2004	Change
Total Assets	\$6,142,955,000	\$5,708,985,000	+ 7.60%
Total Liabilities	\$823,322,000	\$913,891,000	-9.91%
Net Assets	\$5,319,633,000	\$4,795,094,000	+10.94%
Total Revenues, Gains and Other Support	\$837,181,000	\$838,758,000	-0.02%
Educational Expenses	\$176,366,000	\$159,651,000	+10.47%
Management and General Expenses	\$136,276,000	\$136,579,000	-0.02%
Change in Net Assets	\$524,539,000	\$542,528,000	-3.32%
Cash & Cash Equivalents at Beginning of Year	\$53,162,000	\$168,068,000	-68.37%
Net Increase (Decrease) In Cash & Cash Equivalents	\$11,794,000	(\$114,906,000)	+110.26%
Cash & Cash Equivalents at End of Year	\$64,956,000	\$53,162,000	+22.18%

Based upon the consolidated financial statements, notes to the financial statements and supplemental schedules for the fiscal years ending June 30, 2005 and 2004, the unqualified independent auditors' report dated September 16, 2005, the Master's financial consultant's review and analysis of the KPMG's prior years' audit approach and findings, your Master elected to forego any additional review and analysis of KS' receipts and disbursements for the 120th Account Period.

2. Trust Spending.

A review of the Supplemental Schedules of Trust Spending to the KS' Consolidated Financial Statements for the year ended June 30, 2005 indicates that KS actual trust spending before debt financing and reserve activity amounted to

\$226,258,000 or 4.0% in contrast to the budgeted spending amount of \$224,308,000 or 4.5%. Total trust spending after operating reserve activity (amounting to \$3,800,000) was \$222,458,000 or 4.0%. Consequently, during the Account Period, trust spending was within the mid-range of KS' 2½% to 6½% Trust Spending Policy, and at the target level of 4%.

The following table summarizes (in thousands) KS trust spending for the current and past four fiscal years ending June 30th:

	2005	2004	2003	2002	2001
Total trust spending before reserve activity	\$226,258	\$216,057	\$213,466	\$221,846	\$170,706
Total trust spending	\$222,458	\$220,557	\$219,466	\$222,846	\$206,106
Average market value of Endowment	\$5,614,498	\$5,461,640	\$5,392,443	\$5,210,717	\$4,996,812
Trust spending rate before reserve activity	4.0%	4.0%	4.0%	4.3%	3.4%
Trust spending rate	4.0%	4.0%	4.1%	4.3%	4.1%