The following table summarizes (in thousands) KS' actual to budget trust spending for the fiscal year ending June 30, 2005:

<table>
<thead>
<tr>
<th>Trust Spending, Net</th>
<th>Actual</th>
<th>Budgeted</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Campus Based Programs:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kapalama Campus</td>
<td>$56,447</td>
<td>$54,269</td>
<td>-$2,178</td>
</tr>
<tr>
<td>Hawaii Campus</td>
<td>$16,874</td>
<td>$16,426</td>
<td>-$448</td>
</tr>
<tr>
<td>Maui Campus</td>
<td>$15,282</td>
<td>$15,694</td>
<td>+$412</td>
</tr>
<tr>
<td>Outreach Programs:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extension Education</td>
<td>$7,387</td>
<td>$8,854</td>
<td>+$1,467</td>
</tr>
<tr>
<td>Early Childhood</td>
<td>$15,742</td>
<td>$17,156</td>
<td>+$1,414</td>
</tr>
<tr>
<td>Virtual Strategies</td>
<td>$635</td>
<td>$953</td>
<td>+$318</td>
</tr>
<tr>
<td>Land Legacy Education</td>
<td>$4</td>
<td>$96</td>
<td>+$92</td>
</tr>
<tr>
<td>Financial Aid/Scholarships</td>
<td>$17,778</td>
<td>$18,146</td>
<td>+$368</td>
</tr>
<tr>
<td>Ke Ali'i Pauahi Foundation (Net)</td>
<td>$378</td>
<td>$603</td>
<td>+$225</td>
</tr>
<tr>
<td>Other program Expenditures</td>
<td>$13,622</td>
<td>$16,550</td>
<td>+$2,928</td>
</tr>
<tr>
<td>Allocated Support Group</td>
<td>$41,955</td>
<td>$44,395</td>
<td>+$2,440</td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base Spending at Pauahi's Legacy Lives</td>
<td>$186,104</td>
<td>$193,142</td>
<td>+$7,038</td>
</tr>
<tr>
<td>Adjustments: Tuition, Fees &amp; Other Education Income, net of Financial Aid Payments</td>
<td>$(10,313)</td>
<td>$(9,939)</td>
<td>+$374</td>
</tr>
<tr>
<td>Less: Net Income from Ag &amp; Conservation</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Based Distributions</td>
<td>$175,791</td>
<td>$183,203</td>
<td>+$7,412</td>
</tr>
<tr>
<td>Major Repairs</td>
<td>$5,738</td>
<td>$7,095</td>
<td>+$1,357</td>
</tr>
<tr>
<td>Capital Projects</td>
<td>$36,995</td>
<td>$53,276</td>
<td>+$16,281</td>
</tr>
<tr>
<td>Interest on Educational Debt</td>
<td>$7,734</td>
<td>$7,734</td>
<td>-</td>
</tr>
<tr>
<td>Debt Financing</td>
<td></td>
<td>$(27,000)</td>
<td>+$27,000</td>
</tr>
<tr>
<td>Total Trust Spending before Reserve Activity</td>
<td>$226,258</td>
<td>$224,308</td>
<td>-$1,950</td>
</tr>
<tr>
<td>Reserve Activity:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating</td>
<td>$(3,800)</td>
<td>-</td>
<td>+$3,800</td>
</tr>
<tr>
<td>Total Trust Spending</td>
<td>$222,458</td>
<td>$224,308</td>
<td>+$1,850</td>
</tr>
<tr>
<td>Trust Spending Rate before Debt Financing and Reserve Activity</td>
<td>4.0%</td>
<td>4.5%</td>
<td></td>
</tr>
<tr>
<td>Trust Spending Rate for the Respective Fiscal Year</td>
<td>4.0%</td>
<td>4.0%</td>
<td></td>
</tr>
</tbody>
</table>

KS noted that the overall variance in actual expenditures to budget was primarily due to: (1) lower than expected educational programs' salaries and wages, employee benefits, equipment rentals, professional services,
scholarships, and supplies; and (2) a change in the design for Hawaii and Maui Campuses, Phase 5, which resulted in a six-month delay from the original budget and reduced capital project and debt spending.\footnote{KS' Financial & Investment Performance Report, June 30, 2005, at 4.}

While your Master acknowledges that KS has satisfied its minimum trust spending objectives, your Master suggests that the Trustees consider the merits of utilizing a three-year rather than five-year moving average market value determination for trust spending purposes. A three-year moving average may be more appropriate since KS is still in the process of refining its techniques and methodology used to assess the value of its endowment assets. By using a three-year moving average market value, the effect of changes would be incorporated within the shorter time interval and provide a more realistic trust spending rate based upon KS' available resources. A case in point is that KS' five-year average market values of its endowment for June 30, 2005, 2004 and 2003 were $5,614,498,000, $5,461,640,000 and $5,392,443,000, respectively, whereas the market values of its endowment for the same years were $6,765,305,000, $6,216,502,000 and $5,538,310,000, respectively.

Alternatively, the Trustees should consider revising the spending policies based on an inflation adjustment or a formula similar to the Yale University model that incorporates
both inflation and market value. These would result in a better balance between the educational support KS provides currently and the educational support it will provide in perpetuity.  

3. Schedule of Total Return.

Your Master’s review of the Supplemental Schedules of Total Returns attached to the KS Consolidated Financial Statements for the year ended June 30, 2005 indicates that KS’ total return for the Account Period amounted to 12.9% based upon a total portfolio market value of $6,765,305,000 on June 30, 2005. Below is a comparative table of KS’ total return since June 30, 1999 against benchmarks set by the Trust. 

<table>
<thead>
<tr>
<th>Schedule of Total Return</th>
<th>One Year</th>
<th>Three Years</th>
<th>Five Years</th>
<th>Since 6/30/99</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kamehameha Schools Endowment</td>
<td>12.9%</td>
<td>11.2%</td>
<td>7.5%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Market Benchmark (Blended)</td>
<td>9.6%</td>
<td>9.3%</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>CPI+5%</td>
<td>7.5%</td>
<td>7.7%</td>
<td>7.5%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Cambridge Associates Large Endowment Median</td>
<td>13.0%</td>
<td>11.4%</td>
<td>5.3%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

KS investments have performed well in comparison to the selected and disclosed benchmarks. However, your Master points out that KS slightly underperformed the 2005 National Association of College and University Business Officers’ Endowment Study for endowment assets greater than $1.0 billion.

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where the nominal rate of return for fiscal year ending June 30, 2005 was 13.8\%^{34}.

It should be noted that KS’ total return is based on an estimated market value of the KS total portfolio, as disclosed in the Notes to the Schedules of Total Return. The Notes state that the diversity of the KS endowment portfolio necessitated utilization of an array of valuation techniques, factors and assumptions to determine the estimated market values for certain endowment assets. In some cases, original acquisition costs were used to establish the value of certain assets. As a result, the total portfolio market value may not reflect the actual value of some endowment assets, and, accordingly, the actual performance of KS’ investments may differ from that which is reported. However, your Master acknowledges the sincere efforts by KS to develop, compute and disclose the relative total return of KS’ endowment assets based upon the selected market value.

KS is encouraged to continue refining and validating its market value methodologies in order to more effectively and accurately measure value and provide a meaningful and realistic accounting. KS’ Audit Committee’s agreement to authorize its Internal Auditor to commission a study of the Endowment Group’s valuation and benchmark process in FY 2007 is a good example of

\[34\] 2005 NACUBO Endowment Study, Press Release, January 23, 2006, Public Table 1 of 3.
the Trustees' willingness to enhance KS' measurement process under the "best practices" standard.

4. **External Auditors' Comments and Recommendations.**

During KPMG, LLP's audit of KS' Consolidated Financial Statements for the year ended June 30, 2005, certain issues involving internal controls and other operational matters were noted and presented for the Trustees' consideration. Those comments and recommendations, all of which were discussed with the Trustees/Audit Committee, are intended to improve internal controls or lead to other operating efficiencies. These were summarized in Exhibits A and B to the confidential management letter dated September 16, 2005. The internal controls or operating efficiency comments and recommendations dealt with procurement, the commercial property leasing process, enterprise security and Ke Ali'i Pauahi Foundation segregation of duties. KS has indicated that these matters either have been resolved or are in the process of being resolved.

Your Master notes that the commercial property leasing process issue is similar to related issues observed during the Master's review and analysis of KS' leasing activities at Royal Hawaiian Shopping Center in connection with the 117th Master's Report. Your Master has some concerns that KS continues to experience enterprise security issues, in spite of the
significant attention given to and resources expended by the Trust on these issues in recent years.\textsuperscript{35}

Accordingly, your Master strongly recommends that the Trustees assign a high level of priority to these issues of internal controls and operating efficiency to ensure that they are carefully evaluated and timely resolved. Perhaps the Audit Committee would be an appropriate vehicle to provide oversight and direction.\textsuperscript{35}

5. **Internal Audit’s Financial Accountability Projects.**

During this Account Period, KS’ IA completed six direct or indirect financial accountability projects: (1) Campus Cash Controls Audit; (2) Purchasing & Procurement (Campuses); (3) Cash Management/Wire Processes; (4) Commercial Lease Compliance-Percentage Rents Collection and Monitoring Processes; (5) Information Technology Audit; and (6) KAPF Financial/Operational Review. Based upon its evaluation and testing, IA concluded that: (1) Campus Cash Controls and Information Technology (enterprise security) risks were significant enough to require immediate management attention; and (2) Purchasing & Procurement (Campuses), Commercial Lease Compliance-Percentage Rents Collection and Monitoring Processes,\textsuperscript{35}

\textsuperscript{35} See also Deloitte Consulting, LLP, Finance & Administration Cost and Target Efficiency Project (September 29, 2004).  
\textsuperscript{35} See Section B.3 of KS’ Audit Committee Charter.
and KAPF Financial/Operational Review had areas of risk which required management improvements.

Again, your Master strongly recommends that the Trustees assign a high level of priority to the issues of internal controls and operating efficiency to ensure that they are carefully evaluated and timely resolved. The Audit Committee may be an appropriate vehicle to provide oversight and direction.

As previously noted in the Master’s 119th report, your Master continues to believe that, “the Audit Committee and IA should consider rebalancing IA’s function to possibly alternate emphasis from operational risks in one year to financial accounting and reporting risks in the following year.” This recommendation is based upon the perceived need for IA to place more emphasis on assisting KS' Trustees, the Audit Committee, management, KS' independent auditors and the Court to determine and ensure that the financial accounting, reporting and internal controls at KS are adequate and functioning properly.

C. Asset Management.

1. Investment Performance.

   a. Report to the Community.

      The KS Annual Report to the Community for the Account Period reported that the Endowment Fund has

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37 See Master's Report for the 119th Annual Account at 60, 73.
outperformed the long-term objective of CPI+5% since June 30, 1999 (the inception of current performance measurement practice). KS reported investment returns for the period ending June 30, 2005 as:38

<table>
<thead>
<tr>
<th>KS Investment Returns</th>
<th>One Year</th>
<th>Three Years*</th>
<th>Five Years*</th>
<th>Since 6/30/99</th>
</tr>
</thead>
<tbody>
<tr>
<td>KS Endowment</td>
<td>13.2%</td>
<td>11.5%</td>
<td>7.7%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Market Benchmark</td>
<td>9.6%</td>
<td>9.3%</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>CPI+5%</td>
<td>7.5%</td>
<td>7.7%</td>
<td>7.5%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Median Endowment**</td>
<td>10.8%</td>
<td>10.2%</td>
<td>4.5%</td>
<td>NA</td>
</tr>
</tbody>
</table>

* Annualized
** Source: Cambridge Associates (performance of more than 300 endowed organizations)

KS noted that the:

... returns compared well both with market benchmarks and with other endowments. In a broad universe of endowments, KS ranked in the top quartile for the one (fiscal year 2005), three (fiscal years 2003-2005), and five years (fiscal years 2001-2005). Even in earlier years, when financial markets were challenged, Kamehameha's returns out performed the benchmarks.39

A close review and comparison of KS' Investment Returns reported in the Annual Report to the Community with the Supplemental Schedules of Total Return in the Audited Consolidate Financial Statements and Supplemental Schedules for the year ended June 30, 2005 suggests that KS may have been somewhat overly zealous in its reporting of returns to the community.

38 KS Annual Report, June 30, 2005 at 16. For total return, see Schedule at 27, supra.
39 Id.
community. The table below illustrates the differences in reporting by KS for the same periods (in Bold).

<table>
<thead>
<tr>
<th>Periods ending June 30, 2005</th>
<th>One Year</th>
<th>Three Years</th>
<th>Five Years</th>
<th>Since 6/30/99</th>
</tr>
</thead>
<tbody>
<tr>
<td>KS Investment Returns per Annual Report:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KS Endowment</td>
<td>13.2%</td>
<td>11.5%</td>
<td>7.7%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Market Benchmark</td>
<td>9.6%</td>
<td>9.3%</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>CPI+5%</td>
<td>7.5%</td>
<td>7.7%</td>
<td>7.5%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Cambridge Associates' Median Endowment</td>
<td>10.8%</td>
<td>10.2%</td>
<td>4.5%</td>
<td>NA</td>
</tr>
<tr>
<td>Schedule of Total Return per Audited Consolidated Financial Statements:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KS Endowment</td>
<td>12.9%</td>
<td>11.2%</td>
<td>7.5%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Market Benchmark (Blended)</td>
<td>9.6%</td>
<td>9.3%</td>
<td>5.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>CPI+5%</td>
<td>7.5%</td>
<td>7.7%</td>
<td>7.5%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Cambridge Associates' Large Endowment Median</td>
<td>13.0%</td>
<td>11.4%</td>
<td>5.3%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

In addition to these differences in reported returns, your Master observes that KS utilized Cambridge Associates' "Median Endowment" benchmark in its Annual Report to the Community rather than Cambridge Associates' "Large Endowment Fund Median" previously utilized by KS. The Median Endowment benchmark is not appropriate because most of the endowments included in that category have substantially fewer assets than KS. KS should have utilized the Large Endowment Median because its assets of $6.8 billion rank it as the 6th largest endowment in comparison with university endowments in the United States.\(^4\)

Large endowments consistently outperform smaller endowments because they have more available funds to diversify their investments portfolios, are able to tolerate higher risk with higher return, and are able to hire top professional investment

managers to manage their portfolios. Furthermore, as mentioned previously, if KS were to compare itself with the 2005 National Association of College and University Business Officers’ Endowment Study (endowment assets greater than $1.0 billion), the Trust arguably underperformed by 0.9% (13.8% vs. 12.9%) or approximately $61 million ($6,765,305,000 x 0.9%). KS has subsequently agreed that the Cambridge Large Endowment Fund Median is the more appropriate benchmark against which to measure return on endowment.

Your Master recommends that the Executive Team and the Trustees exercise closer scrutiny in the preparation and dissemination of such investment return information to assure greater accuracy, and avoid the potential for inadvertently misleading the public.

b. Operating Reserve Fund.

Consistent with KS Policy adopted pursuant to the Court’s earlier stipulation, the Trust Operating Reserve Fund is targeted at an amount equal to three months of the budgeted Education Expenses for the following fiscal year. During the Account Period, the Operating Reserve Fund balance increased by approximately $2.65 million (net of investment revenue) to $48.69 million. The net return on the operating reserve fund was approximately 2.0% for the year ended June 30, 2005. Since the fund must be liquid and not subject to market fluctuations,
the return is significantly lower than the return on endowment funds.

c. **Benchmark Review.**

In August, 2004, Cambridge Associates, LLC ("Cambridge") completed its review of KS' benchmarks and submitted a report to management in August, 2004 ("Cambridge Report"). As discussed in the Master's Report for the 119th Annual Account, Cambridge reviewed KS' benchmarks against current market expectations for returns, its proprietary database of returns and volatility, and its outlook on capital flows into various asset classes and recommended that certain benchmarks should be revised. Cambridge stated that, generally, benchmarks should reflect the volatility and investment returns an investor would reasonably expect to earn from a passive allocation to each asset class or strategy.

The Cambridge Report recommended three amendments to KS' Investment Policy: 41

1. Decrease the Venture Capital & Private Equity benchmark from CPI plus 10% to CPI plus 8.75%.

2. Decrease the Absolute Return benchmark from CPI plus 8% to CPI plus 5%.

3. Change the rate of return methodology for the Investment Policy Portfolio benchmark.

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41 See Master's Report for the 119th Annual Account at 39-41.
On September 15, 2004, the Cambridge Report was approved by the Trustees and incorporated into KS' Policy 300[T] - Investment Policy.

In December 2005, KS retained Cambridge to assist the Trust with developing annual, interim benchmarks to measure various alternative investments (typically measured using CPI-based indexes over a rolling 10-year evaluation period). This revision is in accord with the recommendation in the Master's Report for the 118th Annual Account. These additional benchmarks were developed for: (1) venture capital and private equity; (2) energy and other inflation-hedging assets; (3) absolute return (alternative investments); (4) Hawaii real estate investments; and (5) fixed income investments. These additional benchmarks were approved for use by the Trustees on October 17, 2006.

Subject to IA's independent consultant's evaluation of the endowment fund measurements in FY 2007, your Master acknowledges and is satisfied that the Trustees continue to strive to improve the processes KS utilizes to more accurately evaluate and measure its investment performance.

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42 See Master's Report for the 118th Annual Account at 87-88.
d. Underperforming and Watch List Assets.

For the fiscal year ended June 30, 2005, KS removed two investments from the Watch List\textsuperscript{43} and moved one investment from the Underperforming List\textsuperscript{44} to the Watch List due to improved performance. The total change in the market value of investments as of June 30, 2005 was a decrease of $18,445,000. Your Master notes that KS provided a summary of Underperforming Investments & Asset/Managers on the Watch List in its quarterly Financial Investment Performance Report. During the Account Period, the Watch List contained $268 million of investments while the Underperforming List contained $814 million of investments. That represents 3.96\% and 12.03\%, respectively, of the $6.8 billion of the market value of the endowment portfolio. The Trustees have closely monitored and continue to closely monitor the Underperforming and Watch List assets, and undertake appropriate measures to improve investment performance.

\textsuperscript{43} The Watch List is a listing of assets or investments which are being carefully monitored due to declining performance.

\textsuperscript{44} The Underperforming List contains those assets or investments with: (1) fair market value below cost; (2) not performing in accordance with KS expectations; (3) not performing favorably when compared to KS' benchmarks; (4) not performing in accordance with the current year's budget; or (5) industry or economic events or trends and/or special information of a significant nature have affected the asset or investment, but are not yet reflected in financial reports.
2. Asset Allocation.

For the fiscal year ended June 30, 2005, KS reported that it has made progress toward the asset allocation targets it set in 2003. Endowment assets have been brought close to long-term target levels in most asset classes, with the exceptions of over allocations to the U.S. Equity class and under allocations to the Alternative Investment class (Absolute Return class, Venture & Private Equity and Energy & Other).

The following table compares the KS Endowment asset allocations as of June 30, 2005 with the allocations as of June 30, 2004, including the current Blended Portfolio weighting (the weightings used to compute the performance benchmark for the overall Endowment Fund), as well as with the Long-Term Asset Allocation Targets.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Allocation 2005</th>
<th>Allocation 2004</th>
<th>Blended Portfolio Weighting</th>
<th>Long-Term Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hawaii Real Estate</td>
<td>26.6%</td>
<td>28.0%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>U.S. Equity</td>
<td>28.4%</td>
<td>29.7%</td>
<td>23%</td>
<td>20%</td>
</tr>
<tr>
<td>Non-U.S. Equity</td>
<td>16.5%</td>
<td>14.0%</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>13.5%</td>
<td>14.9%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>Cash Equivalents</td>
<td>1.0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Alternative Investments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Venture &amp; Private Equity</td>
<td>2.7%</td>
<td>2.5%</td>
<td>3%</td>
<td>10%</td>
</tr>
<tr>
<td>Absolute Return</td>
<td>8.4%</td>
<td>7.2%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Energy &amp; Other</td>
<td>0.6%</td>
<td>0.4%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Real Estate (Mainland)</td>
<td>2.4%</td>
<td>3.3%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

As mentioned earlier, Endowment is in the early stages of a multi-year effort to migrate toward the 10% target for Venture Capital and Private Equity, and the 5% target for Energy
and Other Inflation-Hedging Investments.\textsuperscript{45} KS noted that comparing the Endowment’s June 30, 2005 allocation with the Blended Portfolio weightings, the over allocation to U.S. Equities and under allocation to Energy & Inflation-Hedging Investments represent substantial sources of “benchmark risk,” or risk of underperforming the benchmark.\textsuperscript{46} KS has indicated that this risk will be addressed in the near future with a proposal to reallocate funds from U.S. Equities to marketable Energy and Inflation Hedging assets. However, it is anticipated that it will take several years to actually place committed funds into such investments due to market conditions and the need to reinvest liquidating distributions from maturing investments. Accordingly, it is expected that it will take a number of additional years before the alternative investments category reaches the established target.

The Trustees should continue their efforts to move the KS asset allocations toward their target ranges. Your Master further recommends that the Trustees review and update the long-term asset allocation target on a periodic basis to ensure target percentages provide the desired benefits from risk and return characteristics of each asset class.

During the fiscal year ended June 30, 2005, KS sold some residential land which resulted in substantial gains and

\textsuperscript{45} KS 120th Annual Account: Financial Assets Division at 4.
\textsuperscript{46} Id. at Page 5.
reduced KS' land holdings in its portfolio. However, as your Master has previously noted, KS should periodically review and consider the recommendations contained in the Endowment Group’s Tactical Plan, concerning KS' current policy of holding vast amounts of land which produce very little return. This is a most sensitive issue and one which will not disappear in the near future.

D. The Budget.

1. Actual to Budget.

Your Master notes that this Account Period is the second consecutive fiscal year when actual revenues significantly exceeded budgeted revenues, illustrated in the following table.

<table>
<thead>
<tr>
<th>Revenues</th>
<th>June 30th</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2004</td>
<td>2003</td>
</tr>
<tr>
<td>Actual</td>
<td>$837,000,000</td>
<td>$839,000,000</td>
<td>$544,000,000</td>
</tr>
<tr>
<td>Budget</td>
<td>$465,000,000</td>
<td>$435,000,000</td>
<td>$555,000,000</td>
</tr>
<tr>
<td>Dollar Variance</td>
<td>$372,000,000</td>
<td>$404,000,000</td>
<td>-$11,000,000</td>
</tr>
<tr>
<td>Percent Variance</td>
<td>80%</td>
<td>92%</td>
<td>-2%</td>
</tr>
</tbody>
</table>

In addition, KS' actual expenses have consistently been less than budgeted for the past three years as illustrated in the following table.

<table>
<thead>
<tr>
<th>Expenses</th>
<th>June 30th</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2004</td>
<td>2003</td>
</tr>
<tr>
<td>Actual</td>
<td>$305,000,000</td>
<td>$296,000,000</td>
<td>$264,000,000</td>
</tr>
<tr>
<td>Budget</td>
<td>$326,000,000</td>
<td>$311,000,000</td>
<td>$280,000,000</td>
</tr>
<tr>
<td>Dollar Variance</td>
<td>-$20,000,000</td>
<td>-$15,000,000</td>
<td>-$16,000,000</td>
</tr>
<tr>
<td>Percent Variance</td>
<td>6%</td>
<td>5%</td>
<td>6%</td>
</tr>
</tbody>
</table>

47 Master’s Report for the 115th Annual Account at 20.
KS indicated that the favorable variance in revenues for the Account Period is primarily due to higher than expected net gains on investments and higher than expected residential land sales. Similarly, the favorable variance in expenses is primarily due to delays in filling educational positions, lower insurance costs, lower repairs and maintenance costs, and lower than anticipated professional fees.

Your Master acknowledges the significant contributions that the Trustees have made to enhance Trust revenues. However, your Master believes that greater attention must be given to the annual revenue budgeting process with a view towards revising it. This is evident not only based upon the events of the current and earlier accounting period, but the Master’s observations of the same results for the fiscal year ending June 30, 2006 in which actual revenues were $1,015,300,000 but the budgeted revenues were $561,300,000.\(^4\) While favorable actual results to budget appear to enhance the perception of performance, it can be misleading and result in a failure to properly fund or plan for important programs when there are such significant differences on a consistent basis.

Likewise, though management of KS is commended for administering and operating the organization within approved annual budgets, the Master is concerned that certain budgeted

educational and support programs may have unduly suffered since management indicated during a recent Audit Committee meeting in FY 2006-2007 that funding for certain programs had to be reallocated to cover other, unanticipated costs of other programs.

Your Master reiterates his earlier comment, and those of prior Masters, that KS needs to continue to evaluate and refine its trust spending policy and budgeting process to promote accuracy and to more efficiently and effectively accomplish KS' mission.


A few years ago, KS embarked on changing the budget process from a "funding tool" to a "management tool" with the focus on improving management accountability. That is, the KS budget should reflect an allocation of resources to organizational units to achieve desired goals that are aligned with the KS Strategic Plan.

During the review of the 119th and 118th Account Periods, your Master recommended that KS consider the merits of enhancing the budgetary and budget monitoring process by scheduling periodic forums to assess the accuracy, efficiency

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49 "Funding tool" is the allocation of resources (for budget purposes) based upon historical budget variances and anticipated events to arrive at spending limits. "Management tool" is the allocation of resources (for budget purposes) based upon key performance indicators to achieve desired goals or outcomes.
and effectiveness of the Performance Based Lump-Sum Budgeting System, including requesting the assistance of the Audit Committee and IA assistance in performing a budget process review.\textsuperscript{50}

During the first quarter of FY 2007, IA completed a budget process review and issued its confidential report in November, 2006. IA found that KS had not fully met its objective of changing the budget process from a "funding" tool to a "management" tool to improve accountability. Apparently, some units within KS still consider that the budget is merely a spending limit for the year, rather than an allocation of resources to achieve desired or set goals or outcomes that are aligned with Strategic Plan. IA recognizes that KS is continuing to work on finally implementing the "performance based" component of the lump-sum budget process. In addition, management has developed sufficient budget policies, procedures, guidelines, projection models, which emphasize alignment to CEO team goals and Organizational Strategies. However, IA notes that additional process improvements are needed to emphasize accountability and to continue the migration of the budget process from a "funding" tool to a "management" tool.

In response to IA's findings, management has indicated that because the observations involve executive-level guidance

\textsuperscript{50} See, e.g., Master's Report for the 118th Annual Account at 94; Master's Report for the 119th Annual Account at 110.
and cross-functional collaboration, there will be discussions between the CEO, VP of F&A, Controller, Budget Department and other unit leaders, as deemed appropriate, to develop a more specific action plan. Due to the high importance of the budget process as a valuable Trustee and CEO-Based Management System tool, your Master recommends that future Court-appointed Masters, with IA assistance, review the Trustees' efforts to further monitor and guide the CEO in the development and implementation of a plan to deal with IA's findings and recommendations.

IV

FULFILLMENT OF THE EDUCATIONAL MISSION

A. Overview.

1. Mission and Dedication of Resources.

The primary mission of KS is to provide "educational opportunities into perpetuity to improve the capability and well being of people of Hawaiian ancestry."\(^{51}\) To work towards fulfilling that mission, the majority of the KS budget (both operating and capital expenditures) is allocated to Education. During the Account Period, a total of $153,212,000 was budgeted for Education, or 47% of the KS Budget for Operating

\(^{51}\) See KS Strategic Plan 2000-2015; see also, Will of Bernice Pauahi Bishop: "I desire my trustees to provide first and chiefly a good education in Common English branches, and also instruction in morals and in such useful knowledge as may tend to make good and industrious men and women . . . ."
Expenditures.\textsuperscript{52} This represents an increase of $7,548,000 from FY 2003-2004, or 5%.\textsuperscript{53} Operating Expenditures do not include Capital Improvement Expenditures or major repairs but do include Repairs and Maintenance of existing facilities.\textsuperscript{54} For the Account Period, Education Operating Expenditures were nearly double the budgeted operating expenditures for any other group within KS.\textsuperscript{55}

Similarly, the Education Group (which includes not only the three KS campuses but also Early Childhood Education, Extension Education, Land Legacy Education, the KS Press, Post High Counseling and the Pauahi Leadership Institute) is highly labor intensive and for the Account Period had by far the most employees at KS, 1,431 or 80% of all KS employees.\textsuperscript{56} For the Account Period, the number of Education Group employees increased by 100 or 8% over FY 2003-2004.\textsuperscript{57} In contrast, the Endowment Group has only 73 employees or 4% of the total and the General Support Division has 273 or 16%.\textsuperscript{58}

In addition, by far the greatest amount of resources for Major Repairs and Capital Improvements in the budget for the Account Period was allocated to Education: $467,801,900, or 82%.

\textsuperscript{52} The total KS Budget for Operating Expenditures for FY 2005 was $330,360,000. See, 120\textsuperscript{th} Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "I" at 14-15 (February, 2007).
\textsuperscript{53} Id.
\textsuperscript{54} Id. at 15.
\textsuperscript{55} Id. at 14. The next largest group was Endowment at $80,625,000, or 24%.
\textsuperscript{56} Id. at 11, 15.
\textsuperscript{57} Id.
\textsuperscript{58} Id. at 11.
of the total Capital Budget ($566,622,000). 59 Much, if not most, of the capital improvements budget is for completing the build out of the Hawaii and Maui campuses and for improvements to the Kapalama campus. It is anticipated that once completed, the capital improvements budget for the Hawaii and Maui campuses will be significantly reduced. However, over time the repair and maintenance costs will increase as physical plant ages.

2. Educational Strategic Plan ("ESP").

The KS Trustees approved a 15-Year Strategic Plan in 2000 and a 5-Year Strategic Implementation Plan in 2001. Pursuant to these plans, KS developed strategies and implemented programs to extend the educational reach to more members of the Hawaiian community, with an emphasis on early childhood education.

On June 1, 2005, the Trustees approved the KS Education Strategic Plan ("ESP"). 60 The ESP is an outgrowth of the KS Strategic Plan 2000-2015 and seeks to develop "education focused strategies and approaches to achieve the objectives set forth" in the KS Strategic Plan. 61 Fundamental to the development of the ESP was the overriding principle that the focus and commitment of the KS Trustees and Executive Management

59 Id. at 46.
60 Id., Exhibit "C".
61 See Id., ESP at 6.
must be on education because "education is KS' Core Business."  

More specifically, the plan focused upon early childhood education from ages 0-8 as critical to the "long term intergenerational change in Native Hawaiian individuals, families and communities."  

The focus on early childhood education was the result of research and analyses that demonstrated the importance and benefits of access to early education programs, as well as some rather disturbing facts or statistics about many in the Hawaiian community. For example, studies indicated that Native Hawaiians had higher rates of substance abuse, incarceration, suicide and other risk behaviors than other groups in the State.  

Similarly, based upon standard measures of school achievement, "little progress has been made in Native Hawaiian students achieving parity with their non-Hawaiian peers."  

Generally, measures such as standardized tests, special education enrollment, high school and college graduation rates

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62 Id. at 7.
63 Id. at 8.
64 Research suggests that fifty percent (50%) of a child's ability to learn develops by age four and an additional thirty percent (30%) develops between ages 4 and 8. Between ages 0-3 years, the foundations of thinking, language, vision, attitudes, aptitudes and other characteristics are formed. Early care has long-lasting effects on how people develop, learn, cope with stress and control their emotions.
65 In Hawaii, only 23% of all children ages 3 and 4 attend preschool, and a disproportionately low amount of public funds are expended on children during the periods when brain growth and development are the greatest. See, e.g., Second Supplement to Trustees' Petition for Approval of the One Hundred Twentieth Annual Account (FY June 30, 2005), Exhibit "F" at 18-19.
66 Id. at 12.
67 Id.
reflected "lower achievement among Native Hawaiians compared with statewide norms." 67

In addition, analysis of data indicated an increased need in overall family welfare for Native Hawaiians. Higher rates of public assistance, poverty, isolation in lower wage occupations (particularly since 1990), and dependency ratios (higher numbers of dependents to wage earners) persisted for Native Hawaiians compared to other groups in the State. 68

Another fundamental finding contributed to not only the development of the ESP but to a "high sense of urgency": Currently, 93% of K-12 school age Native Hawaiian children are not served by [KS] campus based programs." 69 That percentage will continue to grow as the Hawaiian population continues to grow. 70 Coupled with the high percentage of Native Hawaiians not served by KS is the recognition that there is a "lag time" between KS efforts and "demonstrated increases in the capability and well-being of Native Hawaiians." 71 The recognition that there are finite resources available to dedicate to these issues helped to underscore the urgency of taking action and the need to develop a plan to °optimize the use of [KS'] endowment

67 Id.
68 Id.
69 Id. at 8 (emphasis added).
70 Id.
71 Id.
resources to benefit the greatest number of Native Hawaiian children possible."  

Consequently, the stated purpose and objective of the ESP are:

The purpose of the Kamehameha Schools Education Strategic Plan is to articulate an integrated strategic focus to enhance and sustain positive educational outcomes for greater numbers of Native Hawaiian children with specific emphasis on young learners (ages 0-8) within the State of Hawaii over the next 5-10 years.

The objective of the Education Strategic Plan is to increase the capability and well-being of the Native Hawaiian people by creating long-term intergenerational change via education.  

The KS ESP is a remarkable document and reflects the undertaking of a monumental effort by KS. It is monumental in scope and will require that increasing amounts of resources be dedicated to it. In addition, the Plan and its implementation must remain focused and disciplined. KS cannot lose sight of the laudable purpose and objective of the ESP. At the same time, there must be sufficient flexibility to terminate projects that are not working and initiate other projects that hold promise. Underlying the entire effort must be the discipline of rigorous oversight, monitoring and the development of accurate

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72 Id. at 9.
73 Id. (emphasis in the original).
74 The ESP projects that over the next ten (10) years the educational strategies and programs will require an increase in annual spending of Trust Estate Resources from approximately $200 million to $300 million. Id. at 29.
methods of measuring the success of individual projects and the overall effort. KS must resist the temptation to merely throw increasing amounts of resources, both financial and human, at the projects without regard to careful cost-benefit analyses to ensure effective and efficient use of KS' considerable, but finite assets.

B. ECE and Outreach Education.

1. ECE.

Neither the ECE nor Community Outreach Education programs is new for KS. The ECE program was initiated more than twenty-five (25) years ago, focusing on pre-school education. KS reports that over this period it has provided quality pre-school education to more than 15,000 pre-schoolers and that currently KS is the largest private pre-school provider in the State. However, recently there has been an increased sense of urgency and more resources have been dedicated to these programs. During School Year 2004-2005 (FY 2004-2005), KS provided preschool education to some 1,439 children at 31 preschools on all islands. KS' preschool program serves approximately fourteen percent (14%) of the Hawaiian preschoolers in the State.

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75 See A Report to the Community, July 1, 2004 - June 30, 2005 at 6.
76 See Second Supplement, Exhibit "F" at 25.
77 Id. KS reports that approximately 2,000 additional children were served through Pauahi Keiki Scholars, Ho`omo`hala Kaiaulu and Hi`ilani Early
The KS' ECE program also involves: (1) the Pauahi Keiki Scholars Program; (2) training for educators in a variety of subjects; (3) sponsoring and co-sponsoring educational conferences; (4) participating in various community activities; and (5) family involvement through the Hi`ilani program (seniors and communities involving parents and/or primary caregivers).\textsuperscript{78} During the Account Period, the Hi`ilani program team expanded its program with the development of curriculum for parent-child interaction programs, parent education and family activities.\textsuperscript{79} The total budget for ECE for the Account Period was $18,105,000.\textsuperscript{80}

The goals and objectives of the ECE program and the renewed emphasis and support for the programs are laudable. However, as with all such programs, vigilance and discipline are required to ensure that the resources are well spent and that the programs are achieving their purposes and goals. This is an area that will require increasing oversight and review by KS and KS' IA.

2. **Community Outreach Education.**

The KS Community Outreach Program is much broader than the ECE program and encompasses a much more diverse and broader

\textsuperscript{78} Id. at 25-26.
\textsuperscript{79} Id. at 26.
\textsuperscript{80} See 120\textsuperscript{th} Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "I" at 16.
range of programs and strategies focused on educational opportunities for Native Hawaiian children from 0-8 years of age. Indeed, ECE is a subdivision under the larger umbrella of Community Outreach Education. However, the delineations between particular programs can be somewhat confusing and appear to cross organizational lines financially, strategically and operationally. For example, KS Preschools is organized under the heading of Child Development but would seem to logically fall within the ambit of ECE. Similarly, Charter School Support would also seem to fall within ECE or Child Development but is a totally separate organizational subdivision under the Community Outreach Education umbrella.

Currently, the KS Educational Group (and Program Structure) is organized as follows:

Education Group
1. Kapalama Campus
2. Hawaii Campus
3. Maui Campus
4. Community Outreach Education
   i. Ho’omohala Kalaulu: Prenatal to Eight Strategic Focus
      a. Supporting Families and Caregivers
         (1) Parent/Keiki Fairs
         (2) Hi’ilani
         (3) Resource Directory
         (4) Birth Baskets
         (5) Home Visits
      b. Child Development
         (1) Pre-K to K Transitions
         (2) KS Pre-Schools (Center Based)
         (3) Traveling Preschool Model

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81 See Second Supplement, Exhibit "F", Appendix B at 70.
82 Id.
c. Literacy Development
   (1) Literacy Resource Materials
   (2) Parent Literacy Workshop
   (3) DOE Restructuring Support - Literacy Enhancement
   (4) Pauahi Book Club

d. Advocacy & Awareness
   (1) Ike Pono
   (2) KHON 2 "First Five" Campaign
   (3) AUW "Born Learning" Campaign

ii. Charter School Support

iii. Virtual Strategies/Distance Learning

iv. Early Childhood Education

v. Extension Education

5. Educational Support and Other Services
   i. Admissions
   ii. Kamehameha Schools Press
   iii. Instructional Technology Support
   iv. Pauahi Leadership Institute
   v. Financial Aid and Scholarship Services
   vi. Ho'oulu Hawaiian Data Center

It is sometimes difficult to determine the allocation of Trust Estate Resources to the various subdivisions of the Education Group and, more particularly, the subdivisions under Community Outreach Education. In the KS budget for the Account Period, there is an allocation for the Education Group and a breakout for some of the subdivisions under Community Outreach Education\(^3\) (such as BCE, Extension Education and Virtual Campus) but not all of them.\(^5\) Indeed, there is no line item allocation in the budget for the broad category of Community Outreach

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\(^3\) Id. According to the 120\(^{th}\) Annual Account: Report to Master & Attorney General, the Pauahi Leadership Institute (5.iv) was dissolved during the Account Period. See, Vol. 1, Exhibit "B."

\(^4\) The same is true for some of the subdivisions of Educational Support and Other Services division. See 120\(^{th}\) Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "I" at 13-17.

\(^5\) Id.
Education.\textsuperscript{86} Presumably and hopefully, there is no confusion at KS with respect to tracking budget allocations and actual expenditures within the various subdivisions and programs within the Education Group when there is no specific line item in the KS Budget. However, your Master was not always able to determine spending allocations for the various subdivisions when there was no line item allocation in the budget, or a reported figure in some other report or document. That process should be clarified.

As mentioned above, under the broad umbrella of Community Outreach Education are a wide variety of programs and efforts focusing on Native Hawaiian children from 0-8 years of age, their parents and/or primary caregivers. These various programs are organized under (or within) five (5) basic groupings (with further subdivisions within some of those groupings: (1) Ho`omohala Kaiaulu: Prenatal to Eight Strategic Focus; (2) Charter School Support; (3) Virtual Strategies/Distance Learning; (4) Early Childhood Education; and (5) Extension Education.\textsuperscript{87} It should be noted that while programs or efforts, such as Instructional Technology Support, Financial Aid and Scholarship Services, the Ho`oulu Hawaiian Data Center and the KS Press do provide outreach education services, benefits and educational opportunities, they are grouped organizationally

\textsuperscript{86} Id.
\textsuperscript{87} See, pp. 56-57, supra.
under Educational Support and Other Services, not Community Outreach Education.\textsuperscript{88} Similarly, the three KS campuses also provide outreach education in a variety of ways, including DOE collaborations and summer school sessions. A number of these various programs appear to cross organizational lines which could well complicate accurate tracking and evaluation of specific programs.

Under the heading of Ho`omohala Kai`ulu: Prenatal to Eight Strategic Focus are four (4) sub-categories: (1) Supporting Families and Caregivers; (2) Child Development; (3) Literacy Development; and (4) Advocacy and Awareness.\textsuperscript{89} One of the ways KS seeks to reach more members of the Hawaiian community, both families and young children, is through various collaborations and partnerships with the DOE and other community organizations. Some of these include: (1) providing homework tutors for after-school programs in cooperation with the Waiakea Settlement YMCA on Hawaii; (2) collaborations with the DOE to provide literacy teaching for younger children; (3) Hawaiian cultural presentations and supplemental learning materials; (4) partnerships with the Foster Parent Association, Child and Family Services; Hawaii Juvenile Justice Project; (5) Pacific Resources for Education and Learning; and (6) collaborations with various community groups to offer workshops on Hawaiian

\textsuperscript{88} Id.
\textsuperscript{89} Id.
culture and career education. While many of these programs again cross organizational lines, most of them, if not all, fall under Extension Education.

Other outreach programs include: (1) traveling pre-school services to families in communities with greater numbers of Native Hawaiians; (2) collaboration with the Institute for Native Pacific Education and Culture (summer kindergarten transition) in specific, targeted communities; (3) accreditation assistance for non-KS preschools; (4) arts education; (5) teacher training; and (6) scholarship support. Financial support of charter schools is another way in which KS seeks to help young Hawaiian children who cannot be served by the three KS campuses. KS support of the charter school program is delivered in two ways: (1) direct financial support to charter schools that emphasize Hawaiian values, culture and language through the Ho`olako Like program (approximately $1.5 million for the Account Period); and (2) contribution to Ho`okako`o Corporation, an independent non-profit entity that operates public schools that have converted to charter schools (approximately $1.65 million for the Account Period for two charter schools (one on Hawaii; one on Molokai).
KS provides funding for scholarships for pre-schoolers and others. The financial aid to preschoolers includes both those attending KS preschools and those who are non-KS preschoolers. KS reported that during the Account Period KS contributed in excess of $2.1 million in financial aid to preschoolers.\textsuperscript{93}

Kamehameha Schools Press also provides outreach services and benefits although it is part of the Educational Support Services division. During the Account Period, KS Press published the first three books of a series (Pauahi Readers) targeted for pre-school children through early elementary school.\textsuperscript{94}

Your Master is pleased that Outreach Education is receiving the attention and resources that it deserves, particularly in light of the fact that the KS campuses can serve only about 7\% of the Hawaiian children in the State. As stated earlier, the outreach efforts require constant monitoring and review to make sure that limited resources (financial and personnel) are wisely used and that the programs are effective. In that regard, KS is quick to point out how many people have been "served" or "reached" by particular programs. Your Master has some concerns about the accuracy of some of the statistics

\textsuperscript{93} Id. Total Scholarship assistance for the Account Period was in excess of $23 million. Id.

\textsuperscript{94} Id. at 15. During the Account Period, KS Press published eleven new titles.
KS used in determining the number of people "reached" or "served." For example, two different documents stated widely-differing numbers of "learners" served by the Extension Education Division during the Account Period. In A Report to the Community, KS states that "more than 13,100 learners" were served by the nine Extension Education Division departments, and footnoted that "some keiki and their families may have received multiple services." However, the Second Supplement, Exhibit "F", states that: "More than 42,000 learners were served by our Extension Education Division’s nine departments . . . ."\textsuperscript{95}

In addition, the Second Supplement to Petition reports that approximately 2,100 non-KS students were served at the three KS campuses during the summer sessions for the Account Period. See, Second Supplement, Exhibit "F" at 3. However, your Master was unable to verify that number by reviewing the reports for each of the KS campuses. Rather, your Master's review suggested that the actual figure was fewer than 1,900.

KS' apparent emphasis on reporting statistics is perhaps best underscored by the figures for the Heritage Center under the Hawaiian Studies Institute for the Account Period. The Second Supplement reports that during the Account Period the Heritage Center "served over 36,493 individuals. As a division,\textsuperscript{95} Compare A Report to the Community at 12-13 (120\textsuperscript{th} Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "E" at 12) with Second Supplement, Exhibit "F at 3.\textsuperscript{95}
over 244,721 instructional materials and approximately 47,162 promotional materials were disseminated.\textsuperscript{96} Your Master is not clear as to how the individuals were "served", the value of the services, or the importance of the number of materials disseminated.

While certainly the number of persons "reached" or "served" may be some indication of the breadth of a program, it is not an indication of the depth or success of a program or justification for its continued support. As stated earlier, accurate methods for measuring success of programs need to be developed and KS must be flexible to quickly abandon programs that do not work and develop new programs that have potential.

C. Financial Aid & Scholarship Services ("FASS").


During the 120\textsuperscript{th} Account Period, IA performed a limited review of Financial Aid in 2006 for award year ("AY") 2006-2007. IA noted that for AY 2006-2007, KS has four FASS programs: (1) Pauahi Keiki Scholars (PKS); (2) PreK12 (Pre K-12); (3) Na Ho'okama (Post High); and (4) 'Imi Na'auao (Post-baccalaureate, merit-based scholarship). The 'Imi Na'auao is a new program, and IA's findings and recommendations with respect to this new program will be discussed in more detail in the Master's report for the 121\textsuperscript{st} Account Period.

\textsuperscript{96} Second Supplement to Petition, Exhibit "F" at 28.
IA's report for the 2006 awarding cycle addressed the following observations and findings which merit the Court's attention:

a. **Alignment of FASS and Admissions.**

There is a need to ensure that consistent methods are used by Admissions and FASS to determine the financial needs of students.

The process of determining an applicant's indigent status utilized by Admissions differs from the process FASS utilized to determine the financial need status of that same individual.

b. **Conflict of Interest.**

There were some weakness of the design of, and effectiveness in, internal controls which address potential conflicts of interest.

c. **Hawaii Ancestry Verification.**

Applicants whose ancestry was verified prior to the establishment of the Ho'oulu Hawaiian Data Center continue to receive KS financial aid/scholarships. That practice should be documented.

d. **Misalignment of Practice with Policy.**

IA noted some instances in which current FASS practices were not aligned with KS Policies. These areas include Hawaiian Cultural Affiliation, Parental Authority, Cost
of Attendance, FASS Appeals Response, and Non-Traditional Status.

Given the highly sensitive nature of the issues of Admissions and Financial Aid, your Master strongly recommends that the Trustees closely monitor management’s efforts to address and resolve the findings of IA and the Audit Committee, including having IA continue to monitor FASS’ progress in correcting its practices and procedures.

2. Financial Aid & Scholarship Gap Between KS and Non-KS Graduates for Post-High Education.

Your Master acknowledges KS’ efforts to enhance its financial aid and scholarship program, which awarded over $14 million during the Account Period. Your Master notes with approval that the gaps between KS and non-KS graduates with respect to the awards percentage and average awards have declined during the past three years.

However, non-KS graduates continue to have a higher denial rate due to application submittal errors compared to KS graduates. This problem persists despite KS’ efforts to bridge this gap by providing additional assistance to applicants, restructuring FASS to include Post-High counselors, and posting additional program assistance information on its website. Your Master also finds the 24% decline in the number of total applicants between 2005 and 2007 very troubling. It is
particularly troubling since there was a 33% decline in applications by non-KS graduates, but a 4% increase in applications by KS graduates during the same period.

It is suggested that the Trustees continue to monitor, enhance and better market the FASS program and its benefits for KS and non-KS graduates of Hawaiian ancestry, since it is clearly one of the most cost-effective means of fulfilling the vision in the Will of Princess Pauahi and accomplishing the mission of Kamehameha Schools.\footnote{Kamehameha Schools' mission is to fulfill Pauahi's desire to create educational opportunities in perpetuity to improve the capability and well-being of people of Hawaiian ancestry.}

The statistical highlights of KS' FASS program and benefits for the respective award years reviewed are shown in the following table (Total KS & Non-KS Graduates, KS Graduate and Non-KS Graduates for Post-High Scholarships):

<table>
<thead>
<tr>
<th>Award Year</th>
<th>Applied</th>
<th>Awarded</th>
<th>Percent Awarded</th>
<th>Awards</th>
<th>Average Awards</th>
<th>Denied Due to Funding or Not Eligible</th>
<th>Percent Denied</th>
<th>Denied Due to Application Errors</th>
<th>Percent Denied</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total KS &amp; Non-KS Graduates:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004-05</td>
<td>4,670</td>
<td>2,734</td>
<td>58.5%</td>
<td>$14,024,950</td>
<td>$5,130</td>
<td>676</td>
<td>14.5%</td>
<td>1,260</td>
<td>27.0%</td>
</tr>
<tr>
<td>2005-06</td>
<td>4,112</td>
<td>2,280</td>
<td>55.6%</td>
<td>$12,733,509</td>
<td>$5,565</td>
<td>634</td>
<td>15.4%</td>
<td>1,190</td>
<td>28.9%</td>
</tr>
<tr>
<td>2006-07</td>
<td>3,561</td>
<td>1,954</td>
<td>54.9%</td>
<td>$14,057,981</td>
<td>$7,194</td>
<td>796</td>
<td>22.4%</td>
<td>811</td>
<td>22.8%</td>
</tr>
<tr>
<td><strong>KS Graduates:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004-05</td>
<td>1,179</td>
<td>814</td>
<td>69.0%</td>
<td>$5,115,696</td>
<td>$6,285</td>
<td>155</td>
<td>13.1%</td>
<td>210</td>
<td>17.8%</td>
</tr>
<tr>
<td>2005-06</td>
<td>1,286</td>
<td>745</td>
<td>57.9%</td>
<td>$4,935,299</td>
<td>$6,625</td>
<td>215</td>
<td>16.7%</td>
<td>326</td>
<td>25.3%</td>
</tr>
<tr>
<td>2006-07</td>
<td>1,227</td>
<td>706</td>
<td>57.5%</td>
<td>$5,355,893</td>
<td>$7,586</td>
<td>318</td>
<td>25.9%</td>
<td>203</td>
<td>16.5%</td>
</tr>
<tr>
<td><strong>Non-KS Graduates:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004-05</td>
<td>3,491</td>
<td>1,920</td>
<td>55.0%</td>
<td>$8,909,154</td>
<td>$4,640</td>
<td>521</td>
<td>14.9%</td>
<td>1,050</td>
<td>30.1%</td>
</tr>
<tr>
<td>2005-06</td>
<td>2,825</td>
<td>1,543</td>
<td>54.6%</td>
<td>$7,798,210</td>
<td>$5,054</td>
<td>419</td>
<td>14.8%</td>
<td>864</td>
<td>30.6%</td>
</tr>
<tr>
<td>2006-07</td>
<td>2,334</td>
<td>1,248</td>
<td>53.3%</td>
<td>$8,702,088</td>
<td>$6,973</td>
<td>478</td>
<td>20.5%</td>
<td>608</td>
<td>25.0%</td>
</tr>
</tbody>
</table>
D. The KS Campuses.

1. General.

The three KS campuses, Kapalama (Oahu), Maui and Hawaii, serve approximately 5,100 students in Grades K-12.96 Kapalama is the largest campus and has a significantly larger enrollment than the other two campuses (approximately 3,197 students vs. 976 for Hawaii (addition of 11th grade) and 967 for Maui (addition of 11th grade)). For the 121st Account Period, the Hawaii and Maui campuses should have their full K-12 enrollment of 1,120 students.97 However, as pointed out earlier, this only represents approximately 7% of the Native Hawaiians of school age in the State.

The build-outs of the physical plants for both the Maui and Hawaii campuses are nearing completion and, consequently, the higher concentration of capital improvement budget allocation and expenditures are anticipated to be significantly reduced for these campuses. In the future, the budget allocations and expenditures for major repairs and capital improvements should be more reflective of the size of the school (number of buildings and students) and the age of the physical plant.

96 Maui and Hawaii campuses have been adding grades at the high school level and now have grades K-12 on each campus.
97 See Second Supplement, Exhibit "F" at 13-16.
It should be noted that Kapalama is the only campus that has a boarding program. That program now serves students from Kauai, Molokai and West Hawaii, islands or areas where there is no KS campus or reasonable access to one. During this Account Period, boarders constituted approximately six percent (6%) of the Kapalama student body.\textsuperscript{103}

All three campuses have been and are participating in the WASC accreditation process. The high school at the Kapalama campus received its six-year accreditation during the Account Period and the middle school began the process with the self study. The Hawaii and Maui campuses are in the accreditation process and the self-study aspect of the process is nearly completed.\textsuperscript{101}

During the Account Period, curriculum mapping was taking place on all three campuses. Curriculum mapping is described as:

\begin{quote}
The process of charting the content skills and knowledge developed of (sic) each course and their comparing this information across each grade level (horizontal articulation) and through the grade levels (vertical articulation).\textsuperscript{102}
\end{quote}

The process potentially can be valuable in improving the content of courses offered, as well as assist in measuring the effectiveness of instruction.

\textsuperscript{100} Id. at 9.
\textsuperscript{101} See Second Supplement, Exhibit "F" at 6, 12 and 14.
\textsuperscript{102} Id. at 6.
All three campuses are involved in various aspects of Community Outreach Education. That involvement varies by campus but includes summer school sessions in which a large percentage of the students are not from KS, collaboration with the DOE and/or community colleges and with other community organizations.\textsuperscript{103}

Your Master notes that, although outside the Account Period, there is an increasing amount of coordination between campuses, implementing consistent and uniform procedures, and seeking to maximize economies of scale to promote efficiencies at better prices (such as food purchases for cafeterias, supplies and athletic equipment).

The position of Vice President of Education has remained vacant, and the headmasters and the heads of the various divisions within the Education Group report directly to the CEO. Your Master does not have serious concerns with this arrangement as a temporary measure since it has permitted the CEO to learn first hand how the Education Group functions and what the major issues are. However, it should not become a permanent means of organization or operation. The responsibilities of the CEO are too great and the duties too varied and demanding for the CEO to have such direct oversight over the Education Group in addition to her other responsibilities. The

\textsuperscript{103} See, e.g., Id. at 12.
(VP Education) position calls for, and requires, someone with educational and administrative expertise who can devote all of his or her efforts to the position.

2. Admissions.

   As discussed in prior Masters' reports, the KS admissions process continues to be a very sensitive and potentially controversial subject. As a consequence, it continues to be assigned a very high priority for review, change and refinement to ensure fairness and consistency.\(^{104}\) Pursuant to that high priority and the KS Admission Policy, the CEO must provide the Trustees with an annual report and quarterly progress reports on the process. In addition, Internal Audit must conduct periodic reviews of the admissions process: comprehensive reports every four (4) years and limited reviews in other years.\(^{105}\)

   The recent, express shift in the admissions policy to give emphasis and preference to Native Hawaiians who are orphans and/or in indigent circumstances necessarily required changes in the KS admissions process. The policy calls for phasing the implementation of the policy over a period of three (3) years, commencing with 2004-2005 Admissions Cycle for

\(^{104}\) See, e.g., Master's Report for the 119th Annual Account of the Trustees at 81-84; Master's Report for the 118th Annual Account of the Trustees at 64-66.

\(^{105}\) See Policy 211[T] KS Admissions Policy, Paragraph 10, Reporting (a.-e.); Master's Report for the 119th Annual Account of the Trustees at 82.
students applying for School Year 2005-2006. The limited review of the 2004-2005 Admissions Cycle conducted by IA included the first year of the implementation of this new policy, for entry points Kindergarten and Grade 4.

IA noted inconsistencies in the indigent selection process between Kindergarten and Grade 4 at the Kapalama campus. However, the Admissions office deliberately utilized two different processes which were designed to test different selection approaches. In addition, some inconsistencies were noted in scores assigned to indigent applicants within the same group of applicants. IA correctly pointed out that inconsistencies in the admissions process both for different entry levels and within a single group tend to cast doubt on the integrity of the entire process. Admissions continues to work to eliminate such inconsistencies.

The limited IA review also reported that Admissions had reviewed ways to “streamline” the Admissions process to make it more efficient and help reduce errors and inconsistencies. Similarly, the Admissions office had made changes to the process in response to findings and recommendations made by IA in prior reviews.

Unfortunately, admission to KS is still unsettled and must remain unsettled until the final disposition of John Doe v. Kamehameha Schools, et al., supra, concerning the
fundamental admission policy giving preference to Native Hawaiians. In addition, it will be a number of years until the full effects of the orphan and indigent policy of 211[T] can be determined. Those effects will necessarily impact financial aid, costs of education and support and tuition. However, your Master is satisfied with the efforts expended and programs made by KS with respect to ensuring the integrity and fairness of the KS admissions process.

b. Applications and Admissions.

For the Account Period, there were a total of 5,700 applications for admission to the three KS campuses, compared with 5,895 for the previous Account Period. Admissions for the three campuses totaled 812 for an overall admission rate of 14.21% (admissions to applications), compared with 13.5% for School Year 2003-2004, 17.5% for School Year 2002-2003 and 14% for School Year 2001-2002.\(^{106}\)

The number of applications and the admissions rates varied by campus and entry level. KS Kapalama is the largest campus, and correspondingly received the greatest number of applications at each entry level. KS Kapalama also had the lowest admissions rate at each entry level, with the exception

\(^{106}\) As noted in the Master’s Report for the 119\(^{th}\) Annual Account, there are various entry points for admission of students at the three campuses. See Master’s Report for the 118\(^{th}\) Annual Account at 8. When the Hawaii and Maui campuses have reached K-12, entry for Grades 10-12 for all campuses will be on a replacement basis only.
of admissions to Grades 10-12, where the Maui campus had a lower admissions rate (5% vs. 9%\textsuperscript{107}). The admissions rates for the three campuses at the different entry levels are listed below.

1. **KS Kapalama.**

   Overall admissions rate 11%.

<table>
<thead>
<tr>
<th>Grade</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kindergarten</td>
<td>7%</td>
</tr>
<tr>
<td>Fourth Grade</td>
<td>7%</td>
</tr>
<tr>
<td>Sixth Grade</td>
<td>N/A</td>
</tr>
<tr>
<td>Seventh Grade</td>
<td>16%</td>
</tr>
<tr>
<td>Ninth Grade</td>
<td>17%</td>
</tr>
<tr>
<td>Grades 10-12</td>
<td>9%</td>
</tr>
</tbody>
</table>

2. **KS Maui.**

   Overall admissions rate 21%.

<table>
<thead>
<tr>
<th>Grade</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kindergarten</td>
<td>16%</td>
</tr>
<tr>
<td>Fourth Grade</td>
<td>32%</td>
</tr>
<tr>
<td>Sixth grade</td>
<td>29%</td>
</tr>
<tr>
<td>Seventh Grade</td>
<td>N/A</td>
</tr>
<tr>
<td>Ninth Grade</td>
<td>22%</td>
</tr>
<tr>
<td>Grades 10-12</td>
<td>5%</td>
</tr>
</tbody>
</table>

3. **KS Hawaii.**

   Overall admissions rate 26%.

<table>
<thead>
<tr>
<th>Grade</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kindergarten</td>
<td>17%</td>
</tr>
<tr>
<td>Fourth Grade</td>
<td>45%</td>
</tr>
<tr>
<td>Sixth Grade</td>
<td>26%</td>
</tr>
<tr>
<td>Seventh Grade</td>
<td>N/A</td>
</tr>
<tr>
<td>Grades 10-12</td>
<td>22%</td>
</tr>
</tbody>
</table>

c. **Other.**

   Your Master notes a very positive development with respect to the KS Hawaii campus which underscores the quality of instruction and education the students at that campus

\textsuperscript{107} The admissions rate for Grades 10-12 at KS Hawaii was 22%.
receive. The Hawaii campus had a disproportionate number of students with low admissions and achievement scores upon entering KS Hawaii. However, achievement test results for School Year 2004-2005 indicated that those students had made significant gains in reading and mathematics. In addition, the results indicated that students who had been in the program longer demonstrated greater improvement.¹⁰⁸

3. Tuition.

The issue of tuition for K-12 students not receiving financial aid at the KS campuses has been discussed in prior reports by Court-appointed Masters. It is a most sensitive, potentially-volatile subject, but one that will not go away. The Trustees, CEO and the Education Group Executive Team have all recognized the importance and sensitive nature of the issue, and the Education Group Executive Team has been engaged in a comprehensive study of it. Over the past year (2005-2006), a study team headed by Dr. Rod Chamberlain, VP Campus Strategies, and Sylvia Hussey (Education Support Services) and guided by the CEO, developed a plan for bringing KS' full tuition to the median of Hawaii parochial schools.¹⁰⁹ That plan has been reviewed conceptionally by the Trustees, and it is anticipated that some action and implementation will occur in the near

¹⁰⁸ See Second Supplement, Exhibit "F" at 11.
¹⁰⁹ While this study and development has occurred outside the Account Period covered by this report, it is an important development that deserves mention now.
future. Implementation of tuition increases would be phased in over a period of five (5) years.

Essentially, the plan calls for changes to KS Policy 225(T) Tuition and Fees that moves tuition and fees for KS students in grades K-12 towards "a structure and levels that align with the KS mission, the KS Strategic Plan and the Education Strategic Plan and reflect the cost and value of a KS education." Your Master perceives this as a welcome change because it recognizes the need to base tuition in large measure on the cost of education and programs and not some artificial benchmark that has little or no relationship to actual costs and results in unreasonable subsidization of students regardless of a family's ability to pay.

The plan also calls for a tuition policy, plan and structure that will provide a mechanism by which tuition and fees may be adjusted to a family's ability to pay and also provides for financial aid to families based upon financial need.

Fundamental to the plan is a commitment to the concept that families of KS students should pay their "fair share" of the cost of a KS education. Obviously, a family's "fair share" will vary, depending upon that family's ability to pay. The plan also takes into consideration Policy 211[T] with respect to the preference for orphans and indigents. Tuition will not
cover 100% of the costs of education (and probably never will) but it will be structured to move towards covering more of those costs.\textsuperscript{110}

The Education Group Executive Team recognizes that the implementation of such a plan will result in a vocal reaction from parents. Consequently, a program for explaining the philosophy and bases for the tuition change must be designed and a mechanism to deal with inquiries put in place.

Your Master commends KS management and the Trustees for their willingness and courage to confront this sensitive and thorny issue in such a direct and forthright manner.

E. Ke Ali‘i Pauahi Foundation ("KAPF").

1. General.

KAPF (sometimes referred to as the "Foundation") is a Hawaii non-profit corporation organized for the exclusive benefit of KS. It engages in fundraising activities for various scholarships and financial aid programs and administers those programs. The Foundation seeks to develop a "culture of giving" and solicit funds from KS alumni, corporations, other charitable foundations and individual planned giving (e.g., charitable remainder trusts).\textsuperscript{111} This Account Period marks the third year

\textsuperscript{110} The study revealed that none of the Hawaii independent schools comparable to KS recovers the full cost of education through the tuition charged.

\textsuperscript{111} See, e.g., 120th Annual Account: Report to Master & the Attorney General, Vol. 1, Exhibit "G" at 1. See also, Id., Vol. 2, Exhibit "N", Notes to Financial Statements, KAPF at 5.
that KAPF has offered scholarships. Over that three-year period, applications for scholarships have increased from 176 to 592.\textsuperscript{112} KAPF awarded 165 scholarships for a total amount of $160,000 compared with 162 scholarships for a total amount of $169,000 for FY 2003-2004. The number of scholarships and the total amount awarded has remained essentially the same due to the lack of change in the amount of funds available for awards. Available funds are limited to 3% of the corpus of KAPF.\textsuperscript{113}

2. \textbf{Financial Status.}

At the end of this Account Period, the net assets of KAPF were $10,755,291, an increase of $2,129,333.\textsuperscript{114} Revenues increased over 2003-2004 primarily as a result of major gifts from the Harold K. L. Castle Foundation ($1.25 million) and the recordation of a Family Trust ($300,000).\textsuperscript{115} Investment income was lower during the Account Period when compared to the previous fiscal year ($669,000 vs. $981,000).\textsuperscript{116} KS reports that the decrease was the result of normal market fluctuations and not under-performance of the investments.\textsuperscript{117} Total return on KAPF's assets was 7.80% compared to the benchmark of 7.37%. The overall return on the investment portfolio since its inception is 7.65% compared to the benchmark of 6.19%.

\textsuperscript{112} Id. at 2.
\textsuperscript{113} Id. at 1-2.
\textsuperscript{114} Id. at Exhibit "G", Overall contributions exceeded budget by $1,155,567.
\textsuperscript{115} Id. at 2.
\textsuperscript{116} Id.
\textsuperscript{117} Id.
Operating expenses also were lower during the Account Period primarily due to unfilled positions within KAPF. In addition, scholarship expenses were lower due to a decline in funding requests for Charles Parrent Grant Funds which are used to support continuing teacher education and fund distinguished visiting scholars.\textsuperscript{118}

3. **Operations.**

In the recent past, the development and growth of KAPF has been hampered by staff turnover, particularly at the leadership level. There has been significant turnover in development positions, donor relations manager and the Executive Director. As a result, KS had to retain an outside fundraising consultant to provide guidance and support to the KAPF with respect to development activities.\textsuperscript{119} However, several of these positions recently have been filled, and it was anticipated that a new Executive Director would be hired in the near future.\textsuperscript{120} Oversight was being provided by the VP of Finance and Administration.\textsuperscript{121} Under the organizational chart for the end of the Account Period, the Executive Director of KAPF reports directly to the CEO.\textsuperscript{122}

\textsuperscript{118} Id.
\textsuperscript{119} Id. at 3.
\textsuperscript{120} On December 1, 2005, Ms. Lynn Maunakea was named Executive Director of KAPF.
\textsuperscript{121} See, 120th Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit "G" at 3.
\textsuperscript{122} See Id., Exhibit "B".
An IA review of KAPF finances and operations was conducted during the Account Period. IA’s report indicated that the internal controls instituted during the staffing transition were not always effective and that there were instances of delays in recording and collecting contributions. In addition, IA noted that the regular monthly and quarterly reviews and reporting of financial and operating results to the Board of Trustees were not occurring.\textsuperscript{123} However, a corrective action plan has been implemented.\textsuperscript{124}

The concept and mission of KAPF are excellent, and KAPF has virtually unlimited potential to be an outstanding source of financial support to provide educational opportunities to Native Hawaiians. With adequate, stable staffing and effective leadership, KAPF should rapidly develop into a major source of financial aid. In that regard, there have been discussions between KAPF and the KS alumni coordinator at Kapalama to coordinate and integrate the functions of each to avoid confusion and duplication and to build “a giving culture.”\textsuperscript{125}

\textsuperscript{123} See Internal Audit Financial and Operational Review of Ke Ali`i Pauahi Foundation (May, 2005) at 1.
\textsuperscript{124} 120th Annual Account: Report to Master & Attorney General, Vol. 1, Exhibit “G” at 3.
\textsuperscript{125} Id.
A. Overview.

The scope of your Master’s review, analysis and assessment of the Trustees’ administration and enhancement of the Trust Estate’s CEO-Based Management System during the Account Period is generally set forth in the New Guidelines and summarized in Section I.G. of this Report. More specifically, the Master’s review, analysis and assessment focused on the following areas or functions:

1. Whether the Trustees are prudently administering, monitoring and improving the KS CEO-Based Management System to ensure that it matures in a fashion that best fulfills the mission of Ke Ali‘i Pauahi’s legacy.

2. Whether critical organizational groups and activities are designed and functioning efficiently and effectively to fulfill the mission of the Trust in accordance with KS Governance Policies and the Strategic Plan.

3. Whether the organizational groups and activities have established plans, policies and procedures to accomplish their respective roles in fulfilling the mission of Kamehameha Schools.
4. Whether measurable progress in the maturation of the CEO-Based Management System is achievable as of the Account Period ending June 30, 2008.\textsuperscript{126}

5. Whether the Trustees with the assistance of its Audit Committee are continuing to objectively identify, assess, prioritize and mitigate potential risks to Kamehameha Schools.

The standards utilized by the Master and his consultant in the review, analysis and assessment of the Trustees' management of the Trust assets are based upon the terms of the Will, applicable law and "best practices."

B. Organizational Structure.

As mentioned earlier, there were a number of organizational changes for the Account Period. KS changed the position title of "Chancellor & CEO" to "CEO", transferred the Continuous Improvement function of the Chancellor & CEO’s Office to the Human Resources Division of the Finance & Administration Group, established a new Hawaiian Cultural Development Office within the CEO’s Office, and reorganized the Education Group into five separate activities reportable to the CEO.

The reorganization of the Education Group resulted in the following changes: (1) the Headmasters of the Kapalama, Maui and Hawaii Campuses report directly to the CEO; (2) establishment of a Community Outreach Education activity, which

\textsuperscript{126} See, Master’s Report for the 119th Annual Account of the Trustees at 56.
also reports directly to the CEO, and oversees Early Childhood Education, Extension Education, Virtual Campus and the Land Legacy Education divisions; (3) establishment of an Education Support Services activity, which reports directly to the CEO, oversees Admissions Division and KS Press; and (4) transferred the Financial Aid Division and Data Center to the Finance and Administration Group.

Other organizational changes included the establishment of a new Community Relations Division, which includes the Community Liaison, the Legislative Liaison and the Neighbor Island Regional Resource Centers; and the combination of Tax and Trust into a new Trust & Tax Administration Legal Division of the Legal Affairs Group.

As a result of these changes, the number of groups and activities which report directly to the CEO increased from five to nine.

In view of the restructuring during, and subsequent to, the Account Period, your Master continues to share the concerns expressed by prior court-appointed Masters that the Vice President of Education vacancy should be filled. Your Master understands and acknowledges the underlying rationale for the interim restructuring of the Education Group, which has allowed the CEO to work directly with the three campuses and other education activities to bring about positive changes.
through better collaboration. However, your Master is concerned that the CEO may be, or could well become, over extended and that prolongation of the current interim Education Group structure without the appointment of a Vice President of Education could have detrimental consequences.

C. CEO-Based Management Assessment.

In assessing the administration, enhancement and maturation of KS' CEO-Based Management System, your Master considered the Trustees' annual calendar year self-assessment minutes, relevant Internal Audit reports, and interviews with the CEO and her Executive Management Team. Your Master also received and considered each Group's quarterly or other periodic reports to the CEO and/or Trustees. This assessment includes the Trustees, IA, the CEO and the Financial and Administration Groups.

1. Trustees.

The Master has reviewed the minutes of the Board of Trustees dated January 4, 2005 and 2006, which discuss the Trustees' assessment of governance matters for calendar years 2004 and 2005 under the leadership of Nainoa Thompson and Diane Plotts, respectively. Highlights noted in the Board's self-assessment during the last six months of the calendar year 2004 and the first six months of the calendar year 2005 with Dee Jay Mailer firmly in place as the new CEO were:
a. Reestablishment and strengthening of the KS CEO-Based Management System;

b. Reestablishment of trust, confidence, pride and enhanced working relationship between the Board, CEO and her executive team;

c. Allowing the Trustees to readily delegate authority, focus attention on strategic direction and oversight, and minimizing the need for the Board to assist the executive leadership team with critical operational issues;

d. Revision of KS’ Governance Policy due to the expiration of the IRS’s Closing Agreement in February, 2005, which policy was approved by the Court in December, 2005;

e. Allowing the CEO sufficient latitude to lead and reshape the educational, endowment and finance & administration strategies needed to successfully pursue the mission of KS in perpetuity; and

f. Providing for a more effective executive leadership team led by the CEO to direct changes that have been slow to happen in the past in order to accelerate the improvement and implementation of KS programs to accomplish its mission.
Based upon your Master’s review, observations and discussions with the Trustees, the CEO and her Executive Management Team, it is evident that KS is well on its way to firmly establishing and refining the Court-ordered CEO-Based Management System and ensuring its maturation. However, as noted in your Master’s 119th Report, while the management system is now firmly established, the Trustees must continue to monitor the progress and foster its maturation since it will take some time for the new governance “culture” to permeate through the entire organization.

2. **Internal Audit (“IA”).**

   a. **Projects Initiated.**

   During this Account Period, IA reported to the Audit Committee on August 9, 2005 that it initiated 21 projects of which 15 projects were completed. The following table lists the categories and status of these 21 projects.

<table>
<thead>
<tr>
<th>Project Category</th>
<th>Completed</th>
<th>Uncompleted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assurance &amp; Compliance</td>
<td>8</td>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>Consulting &amp; Special</td>
<td>2</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Carryover from Prior Fiscal Year</td>
<td>3</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Function Administration</td>
<td>2</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>15</td>
<td>6</td>
<td>21</td>
</tr>
</tbody>
</table>

   b. **Outstanding Recommendations.**

   In that same report, IA noted that:

   The number of outstanding IA recommendations remained relatively constant since the last quarter (78 this quarter vs. 79 last quarter); however, the number of recommendations due
within 3 months decreased 62% (from 39 to 15) while the number of recommendations due beyond 3 months increased 51% (from 39 to 59). Consistent with last quarter’s 48% completion rate for recommendations “due within three months,” 46% (18 of 39) were completed this quarter and 41% (16 of 39) received extended due dates, with 8 of the 16 being extended more than once, 1 was extended five times, and 7 were extended six or more times. IA noted that no action was taken on 2 recommendations “due within three months” and 3 recommendations became overdue.\textsuperscript{127}

As noted by previous Court-appointed Masters, your Master is concerned with the delays in resolving agreed-upon findings and recommendations made by IA and reported to the Trustees/Audit Committee. These delays and extensions are particularly troublesome in light of IA’s five common risk exposure objectives, which are applied to all assurance projects: (1) strategic alignment to mission; (2) operational effectiveness and efficient use of resources; (3) reliability and integrity of reported information; (4) compliance with policies, directives, procedures, plans, laws and regulations; and (5) prevention of loss of the organization’s assets or resources.

Extended delays in resolving IA’s agreed-upon findings and recommendations cannot be tolerated. Your Master believes it is reasonable for KS to resolve most of IA’s agreed-upon findings and recommendations.

\textsuperscript{127} See KS Audit Committee Quarterly Reports for most current status.
recommendations within six to eighteen months after they have been reported and accepted.

Your Master strongly recommends that the Trustees initiate a collaborative effort to have management expeditiously resolve these outstanding exposures. The Master also recommends that commencing with the 121st Account Period that the Trustees prepare and submit to future Court-appointed Masters a report on all outstanding IA findings and recommendations pending resolution for a period of more than six months, which shall address the Trustees' action plan to resolve such outstanding recommendations.

In addition, your Master recommends that the Trustees continue to closely monitor and evaluate the outstanding IA recommendations regarding the implementation of the CEO-Based Management System, previously noted in the Master’s 119th Report and included in KS’ IA’s Follow-up on Completed Recommendations (FY2003/2004) Report dated August, 2005, such as:

1. The need to complete the comprehensive Organization - Wide Tactical Plan (the next step in defining the efforts of KS to meet the mission and goals articulated in the Strategic Plan);

2. Improve the Effectiveness of Internal and External Communications; and
(3) Adopt an Organization-Wide Change Management Process (permeation of the new governance culture through the entire organization).

3. The CEO.

During the course of the Master’s interview with the CEO during FY 2005-2006 regarding the 119th Account Period, Dee Jay Mailer expressed her intent to:

a. Resolve certain concerns noted by previous Court-appointed Masters to mitigate potential risks in KS' CEO-Based Management System and enhance the management system to efficiently and effectively fulfill the educational mission of the Trust Estate.

b. Fill critical executive level managerial positions.

c. Develop an affirmative program to retain qualified executive managerial personnel.

d. Develop a succession plan to minimize the impact of critical managerial personnel turnover.

e. Mentor and promote qualified managerial personnel from within KS whenever possible.

Your Master concurs with CEO’s efforts to accomplish these objectives. Your Master encourages the Trustees to work with the CEO in fulfilling her intent to address and resolve
these very important, if not critical, human resources issues by June 30, 2008.

D. **Finance & Administration Group.**

1. **The Deloitte Study.**


   a. **Objectives of the Study.**

      The primary objectives of the Deloitte Study were to: (1) establish baseline cost structure and identify cost components with the most significant opportunities for efficiency (which ultimately equates to cost savings); (2) identify cost efficiency initiatives within each division; and (3) develop tactical plans to implement the Group’s strategic plan initiatives and identified cost efficiency initiatives.

   b. **Areas of Concern.**

      Concerns observed by Deloitte during the study were: (1) information systems applications were not integrated
and scalable and did not adequately support institution requirements; (2) manual processes were not integrated based upon workflow but rather by departments; (3) specific divisions required better definition of their roles and responsibilities due to changes within the organization, which impacted their ability to best service customers; (4) inadequate policies and procedures to support ownership and accountability, operational efficiencies and cost savings; and (5) the existing operating metrics or performance management system were difficult to monitor, foster accountability and reinforce behavior on a consistent basis, which impacted alignment with the Group’s overall strategic plan.

2. **Key Observations & Opportunities for Improvement.**

Key observations and opportunities for improvement identified by Deloitte based upon cross-industry averages were:

a. **Group Manager to Staff Ratio.**

The Group should increase its manager-to-staff ratio (span of control) which is below industry average to enhance productivity and management effectiveness and reduce overall operating cost.

b. **Controller Division.**

The Controller Division should increase its overall productivity and reduce operating costs to align with current productivity levels.
c. **Treasurer Division.**

The Treasurer Division should reduce large average cash balances and utilize excess funds in higher return investments.

d. **Facilities Development & Support Division.**

The Facilities Development & Support Division should shift its focus to managing high dollar and high risk projects. The average dollar per project managed by staff is below industry average (75% of projects managed are under $500,000, which makes up 20% of the total spending).

e. **Information Technology Division.**

The Information Technology Division should: (1) reduce operating costs to align with customer service levels; (2) increase customer service and support levels; (3) align spending with KS requirements to potentially reduce unnecessary spending and realize volume discounts as spending is managed with limited controls and business justification; and (4) increase implementation rates of recommended initiatives and/or strategies to maximize benefits to KS' organization based upon previous studies.

f. **Human Resources Division.**

The Human Resources Division should reduce its operating costs to align with cross-industry standards.
Deloitte estimated that KS could realize a significant efficiency gain annually by the third year if the initiatives contained in its report are initialed.

3. **Finance & Administration’s Actions.**

Based upon the Deloitte Study, the Group, led by VP Michael Loo, CPA, has worked on developing a three-year strategic plan in alignment with KS’ Strategic Plan to implement many of these initiatives. The customer support and operating performance initiatives identified in the Deloitte Study as cost efficiency initiatives were addressed by the Group and its respective Divisions. The effort provided a roadmap for implementation in FYE 2005 and 2006 with any residual initiatives being implemented in FYE 2007. The Group’s Strategic Plan also established a framework for ongoing monitoring and performance management of the initiatives.\(^{128}\)

The Group’s overall targeted cost efficiency gain (cost reduction) is anticipated to be lower than that estimated by Deloitte after implementation of the initiatives in the third year. Mr. Loo indicated that the Group’s costs to KS’ overall operating budget will be approximately 12% after instituting the cost efficiency changes. That is slightly higher than the national norm of 10% to 11% and is primarily due to the organization’s uniqueness. Your Master notes that the higher

\(^{128}\) KS F&A Strategic Plan (January 2005).
cost is, in part, due to the ongoing effect of replacing the "Lead Trustee System" with the CEO-Based Management System of governance, and correcting the systemic problems associated with past governance practices.

Outstanding and pending Group actions identified were: (1) obtaining organizational "buy-in" and funding to execute implementation of the initiatives; (2) continue to build and mobilize strategic initiative project teams; (3) institute an initiative monitoring and performance management process.\(^{129}\)

Mr. Loo also noted that he plans to have follow-on evaluations conducted at least every three-to-five years to assess the Group's progress and performance, and to reassess its vision for the next three-year period.

As noted by the previous Court-appointed Masters, KS Trustees continue to make significant strides towards prudently administering, monitoring and improving KS' CEO-Based Management System to ensure that the new management structure matures in a fashion that best fulfills the mission of the Ke Aliʻi Pauahi's legacy. The engagement of Deloitte to assist KS and the Group to independently evaluate and assess finance and administration baseline costs and targeting of efficiency projects is an excellent example of the Trustees' emphasis on the efficient and

\(^{129}\) Id.
effective fulfillment of KS' mission in accordance with the Trust Governance Policy and the Strategic Plan.

It should be noted that the Finance & Administrative Group has incorporated many, if not all, of the recommendations contained in the Deloitte Study in connection with the development of the Group's three-year strategic plan.

Due to the nature, importance, the complexity and size of the Finance & Administration Group, and the substantial potential cost savings to KS, your Master recommends and requests that the Trustees, with the assistance of IA: (1) monitor the Group's implementation and monitoring process of the three-year Strategic Plan for these initiatives; and (2) report on the progress toward attaining the targeted efficiencies. In addition, the Trustees should closely review the Group's progress to ensure that the optimum efficiencies are, in fact, realized. Furthermore, the Trustees should review and validate (or not) the Group's belief that over time it will be unable to achieve and realize the upper limit of the range of cost efficiency gains identified by the Deloitte Study.

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MASTER'S RECOMMENDATIONS

A. Composition of Audit Committee.

In the Master's Report for the 119th Annual Account of the Trustees, your Master discussed the subject of possible
changes to the KS Audit Committee and recommended that the Trustees consider modification of the KS Audit Committee to include a qualified, independent member or members.\textsuperscript{130}  The Order Granting Trustees' Petition for Approval of the One Hundred Nineteenth Annual Account (FYE June 30, 2004), filed October 4, 2006 granted the Petition subject to the recommendations of the Master contained in the Master's Report and:

Subject further to the Petitioners [Trustees], the Master and Attorney General developing and agreeing to a plan to implement changes to the Audit Committee consistent with the objectives of the Master's recommendations as set forth in the Master's Report.\textsuperscript{131}

Your Master has neither seen a draft of proposed changes nor had any discussions with the Trustees concerning this provision of the Order since it was filed. However, your Master is aware that the Trustees have had some internal discussions of the subject and anticipates and trusts that there will be substantive discussions between the Trustees, the Master and the Attorney General in the near future.

B. **Asset Allocation.**

The asset allocations are either in line with KS' target or are moving toward the targeted percentage. However, your Master recommends that KS review and consider the viability of the recommendations contained in the Endowment Group's

\textsuperscript{130} See Master's Report for the 119\textsuperscript{th} Annual Account at 63-69; 110.
\textsuperscript{131} See Order Granting Trustees' Petition for Approval of the One Hundred Nineteenth Annual Account (FYE June 30, 2004) at 2.
Tactical Plan concerning KS' current policy of holding vast amounts of land which produces very little return. This is a very sensitive and controversial issue. While your Master is aware of the different "values" that land provides to the Trust Estate besides production of income, given Pauahi's vision and legacy and KS' mission, this is a subject that requires periodic review by Management, the Trustees and future Court-appointed Masters.

The Trustees should continue their efforts to improve KS asset allocation toward the established target ranges. Your Master further recommends that the Trustees regularly review and update its long-term asset allocation targets to ensure that the target percentages provide the desired benefit from risk and return characteristics for each asset class.

C. Revenue Budget Process.

Your Master acknowledges the significant contributions that the Trustees have made to enhance Trust revenues, improve the migration of assets and increase net assets. Your Master recommends that more attention should be given to the annual revenue budgeting process with a view towards revising it. This is evident since KS' actual revenues have exceeded budget by 80% or more for the fiscal years ending June 30, 2006, 2005 and 2004. While favorable, the significant revenue disparity may
result in possible failure to properly plan for or fund KS programs, activities and alternate investments.

D. **Financial Aid & Scholarship Services.**

Given the highly sensitive nature of the issues noted in IA’s December 2006, Financial Aid Limited Review: 2006 Awarding Cycle Applicants to SY 2006-2007, your Master recommends that the Trustees closely monitor management’s efforts to address and resolve IA’s findings.

E. **Outstanding Agreed-Upon IA Recommendations.**

Extended delays in resolving IA’s agreed upon findings and recommendations should not, and cannot, be tolerated. Your Master believes it is reasonable for KS to resolve most of IA’s agreed-upon recommendations within six to eighteen months after they have been reported and accepted.

Your Master recommends that the Board of Trustees exert a collaborative effort to have management expeditiously resolve these outstanding exposures to risk. The Master also recommends that, commencing with the 121st Account Period, the Trustees prepare and submit to future Court-appointed Masters a report on all outstanding IA findings and recommendations pending resolution for a period of more than six months, which shall address the Trustees’ plan to resolve these outstanding recommendations.

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In addition, your Master recommends that the Trustees continue to closely monitor and validate the outstanding IA recommendations regarding the implementation of the CEO-Based Management System, previously noted in the Master's 119th Report, which are contained in KS' IA's Follow-up on Completed Recommendations (FY2003/2004) Report dated August 2005.\textsuperscript{132}


The Master previously recommended in the 119th Report that the Board of Trustees submit a "Self-Evaluation Report" to the then-Court-appointed Master commencing with the 120th Annual Account, which was approved by this Court.\textsuperscript{133} The report should summarize the Trustees' achievements during the Account Period as set forth in KS' Governance Policy and specifically address each of the eight specified governance requirements under "Role of Trustees", which are listed on pages 3 and 4 of the current Governance Policy. This Self-Evaluation Report shall be submitted as a supplement to Section V.A.5 of the New Guidelines, "A summary of significant accomplishments and future plans and a discussion on the major decisions and events occurring during the fiscal year." Your Master requests that this Court direct the Trustees to prepare and submit their Self-Evaluation Report, commencing with the 121st Annual Account.

\textsuperscript{132} See Master' Report for the 119th Annual Account at 48-51.
\textsuperscript{133} Id. at 57-58.
Report format in connection with performing their annual
calendar year self-assessment as referred to and discussed in
Section V.C.1 of this Report, since the requested report is more
comprehensive.

G. **Suspense Date for KS Trustees’ Reports.**

As recommended in the Master’s Court-approved 119th
Report, due to the desire for the Trustees, Master and Court
to improve the timeliness of the filing of the Master’s report,
all petition contents and exhibits contained in the New
Guidelines, including other previously-requested information,
need to be coordinated by KS and submitted to the
then-Court-appointed Master no later than September 15th
following the filing of the petition for subsequent Account
Periods.\(^{134}\) However, for the 121st Account Period, your Master
recommends that the Trustees for KS coordinate, prepare and
submit to the then-Court-appointed Master all petition contents
and exhibits contained in the New Guidelines to the Master by
May 31, 2007 in order to close the gap between the filing of a
Petition and submission of the Master’s Report.

\(^{134}\) Id.
A. General.

During the Account Period, KS continued to move forward on a number of fronts: (1) refining the organization and structure of the Executive Management Team; (2) improving the efficiency of the various divisions and coordination between divisions; (3) development of the new Educational Strategic Plan and developing new outreach programs and strengthening existing ones; and (4) pushing to extend the culture of the CEO-Based Management System throughout the entire KS organization.

Organizationally, the position of VP of Education remains vacant. While the VPs of Strategic Planning and Implementation and Campus Strategies perform some of the functions of VP of Education, the CEO remains directly involved in the educational activities of KS. Your Master believes that ultimately a VP of Education will be necessary in order to relieve the CEO of some of her current duties and time constraints with respect to educational matters and enable her to devote more time to her duties and responsibilities for all of the other functions and operations of the Trust Estate. Someone with the appropriate expertise in education and administration would be of valuable assistance to the CEO and the Trust Estate.
B. **Review Process.**

The implementation of the New Guidelines for this Report resulted in some delays in the production of materials. In particular, the 120th Annual Account: Report to Master & Attorney General required additional effort and time to compile. However, this report provides valuable information in a format and organization that is very useful. It is an excellent improvement. Your Master believes that, for future reviews and Master’s Reports, this new report required by the New Guidelines will actually make the Master’s and AG’s reviews more efficient and timely.

The cooperation of the Trustees, CEO, Executive Management Team and KS’ IA was outstanding. As in past reviews of annual Account Periods by your Master, there was no subject that was not open for discussion or any information or documents that were withheld. Again, your Master and his financial consultant had unfettered access to the Trustees, CEO and her Executive Management Team and IA. That access was, and is, indispensable in gathering information and gaining insights into the operations of the Trust Estate and the maturation of the CEO-Based Management System. Colleen Wong and Eric Sonnenberg were indispensable in coordinating requests for information made by your Master and his financial consultant. Your Master is most appreciative of, and grateful for, the assistance, access
and openness of the Trustees, CEO, Executive Management Team and IA.

Your Master would be remiss if he did not mention his financial consultant, Howard Kam, Jessica Su and the staff at Horwath Kam & Company. Their expertise in accounting, finance and operations is indispensable. Not only is their work invaluable to your Master's review and Report to the Court, but the entire community benefits from their comprehensive, careful and insightful work.

C. Request.

Your Master respectfully requests that this Court:

1. Issue an Order summoning the Attorney General to appear and show cause, if any, as to why the Trustees' Petition for Approval of the 120th Annual Account should not be approved as rendered, subject to consideration of the recommendation of your Master; and

2. Grant the Master's request for fees, costs and expenses incurred in preparing this Report for the 120th Annual Account. Details of the fees, costs and expenses will be provided to the Trust Estate, Attorney General, and the Court prior to the scheduled hearing on the subject Annual Account.

DATED: Honolulu, Hawaii, April 5, 2007

DAVID L. FAIRBANKS
Master for the 120th Annual Account
IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAI`I

In the Matter of the Estate ) EQUITY NO. 2048
of ) CERTIFICATE OF SERVICE
BERNICE P. BISHOP, )
Deceased. )

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing document was duly served by hand delivery on the following on

April 5, 2007:

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DATED: Honolulu, Hawai`i, _______April 5_______, 2007.

DAVID L. FAIRBANKS
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