



KAMEHAMEHA SCHOOLS

CLOSING AGREEMENT COMPLIANCE REPORT

February 22, 2001

Table of Contents

	PAGE
Background	1
Purpose of Report	2
Executive Summary	2
Closing Agreement Sections:	
<i>A.1.A. Permanent Removal of Incumbent Trustees</i>	3
<i>A.1.B. Incumbent Trustees Resignation from Directorships</i>	4
<i>A.1.C. Communications Among Trustees</i>	4
<i>A.1.D. Role of Trustees</i>	5
<i>A.1.E. Suspension or Removal of Former Trustees</i>	6
<i>A.1.F. CEO Management Structure</i>	7
<i>A.1.G. System of Checks, Balances and Affirmative Disclosure Requirements</i>	11
<i>A.1.H. Conflict of Interest Policy; Financial Disclosure Statement</i>	15
<i>A.1.I. Comprehensive Educational and Strategic Plan</i>	16
<i>A.1.J. Investment Policy and Investment Performance Reports</i>	17
<i>A.1.K. Spending Policy</i>	18
<i>A.1.L. Trustee Compensation Committee</i>	20
<i>A.1.M. CEO Compensation</i>	20
<i>A.1.N. Audited Financial Statements</i>	21
<i>A.1.O. Internal Auditor Function and Related Policies and Privileges</i>	22
<i>A.1.P. Review of Contractual Relationships</i>	27
<i>A.1.Q. Review of Significant Job Classifications</i>	29
<i>A.1.R. Procurement Policy</i>	31
<i>A.1.S. Employment and Contract Policies and Procedures</i>	32
<i>A.1.T. Employment of Government Officials</i>	33
<i>A.1.U. Documentation of Trustee and Top Executive Decisions</i>	35
<i>A.1.V. Prohibited Political Intervention Policy</i>	37
<i>A.1.W. Lobbying Policy</i>	37
<i>A.1.X. Controlling Interest</i>	38
<i>B.1. Settlement of Tax and UBIT Issues</i>	40
<i>C.2. Closing Agreement Available to the Public</i>	40
<i>(Note: Sections A.1.Y, B.2-B.7, C.1,C.3-C.7 do not include requirements for action)</i>	
Conclusion	41

Exhibits

Exhibit No.

Kamehameha Schools Organizations	A
Kamehameha Schools Consolidated Financial Statements	B
Resume of Dr. Hamilton I. McCubbin	C
Kamehameha Schools Organization Chart	D

BACKGROUND

The Interim Trustees¹ of Kamehameha Schools (“KS” or “Trust Estate”), formerly known as Kamehameha Schools Bishop Estate, following the resignation of all of the Incumbent Trustees, entered into the “Closing Agreement on Final Determination Covering Specific Matters” (the “Closing Agreement”) with the Internal Revenue Service (“IRS”) dated February 23, 2000 (the “Effective Date”). The Closing Agreement covers the interests of KS, its subsidiaries and affiliated organizations (collectively, “KS Organizations”). The Closing Agreement resolved KS audit and UBIT tax issues covering the 1990-1996 time period and the “credit enhancements issue” for the 1990-1998 time period and allowed KS to preserve its tax-exempt status, subject to the terms and conditions of the Closing Agreement.

The Closing Agreement includes Parts A (Resolution of Audit Issues Relating to KS(BE)’s Exempt Status), B (Settlement of UBIT and Tax Issues) and C (which describes, among other things, the term of the Closing Agreement and filing instructions). Part A has twenty-five separate sections labeled sections A through Y, but only sections A through X require action on the part of the KS Organizations. Parts B and C each have seven separate sections labeled 1 through 7, but only sections B.1 and C.2 require action on the part of the KS Organizations.

Part A, Section O. of the Closing Agreement calls for the Internal Auditor to monitor the KS Organizations’ compliance with the terms and conditions of the Closing Agreement. The Internal Auditor must report to the IRS on the KS Organizations’ compliance efforts over the five-year term of the Closing Agreement beginning with the Effective Date. The report to the IRS will be made annually in the form of a “Special Filing,” a copy of which will be provided to KS and the Attorney General of the State of Hawaii, as *parens patriae* (“AG”). During this five-year period, if there is no material breach of the terms and conditions of the Closing Agreement, the IRS will not take steps to revoke KS’ tax-exempt status.

In addition to the Special Filing by Internal Audit, certain sections of the Closing Agreement require the KS Organizations to report to the IRS within a specified period of the Effective Date on the KS Organizations’ actions taken to satisfy or implement the conditions of those sections. Other sections require the KS Organizations to provide a copy of or make available to the IRS, the AG, the court appointed Masters, the Probate Court, or a combination of them, the KS Organizations’ efforts to satisfy the conditions of those sections.

The IRS audit included issues that arose during the annual accounting periods of KS from July 1, 1993 through June 30, 1999 (the “109th through 114th Annual Accounts”). The 109th through 114th Annual Accounts were finally approved by the Probate Court by Orders entered January 30, 2001. The Court’s Orders approving the 109th through 114th Annual Accounts resulted in the Incumbent and Interim Trustees being discharged and released from liability, the approval of all transactions during said period, and the satisfaction of all Court Orders and Stipulations. Internal Audit is monitoring KS’ compliance with the Court Orders and Stipulations entered after June 30, 1999.

¹ Capitalized terms, unless otherwise defined herein, shall have the same meanings as described in the Closing Agreement.

PURPOSE OF REPORT

The purpose of this Report (the “Report”) is twofold. First, this Report serves to satisfy the reporting requirements of the KS Organizations under the Closing Agreement for the period which began with the Effective Date and ends on the date of this Report. Second, while not every section specified above in Parts A, B and C requires reporting to the IRS or to all of the above named parties, this Report also serves to provide notice to all of the parties of the KS Organizations’ good faith efforts to comply with the terms and conditions of the Closing Agreement.

In this Report, the full terms of each section that required the KS Organizations to take action and on which KS now reports are stated and are followed by a summary of the action taken and KS’ representation of the current status. Many sections require the KS Organizations to take more than one action. In those instances, the provisions of those sections have been modified by inserting numbers in brackets before each provision requiring action. The summary under each section is then broken into parts and organized to track the bracketed numbers in each section. The current status of each part follows the summary of each bracketed number.

EXECUTIVE SUMMARY

The efforts taken by the Interim Trustees, together with the Chief Executive Officer (“CEO”) and the respective Chief Executives of KS (see Section A.1.F.) and the officers/directors of the other KS Organizations, include the following initiatives instituted to comply with the Closing Agreement:

- Re-implementation of the Internal Audit function, which has been outsourced to Arthur Andersen LLP.
- Periodic updates to the Trustees (the term “Trustees” includes the Interim Trustees and/or those appointed as Trustees effective January 1, 2001, as appropriate) and CEO by management and Internal Audit to ensure the Trustees and CEO are informed of issues and matters of interpretation regarding the Closing Agreement.
- Creating a tracking data base to monitor, update and document relevant matters for each Closing Agreement section.
- Discussing matters of interpretation with outside advisors for guidance and conferring with the IRS as necessary.
- Frequent discussions with Internal Audit on issues and seeking input on clarification of various matters pertaining to the Closing Agreement.
- Holding monthly Closing Agreement status meetings at which time management of KS Organizations and Internal Audit collectively discuss progress.

- Meeting between the CEO and the IRS in February 2000 to discuss matters relating to the Closing Agreement.
- KS development of the annual report to the IRS (herein) to summarize the status of KS Organizations' implementation of the Closing Agreement. Copies of this report are also being distributed contemporaneously to the Court Masters and the AG and will be filed in Probate Court.

Through these efforts and initiatives, KS will be better able to remain focused on its primary mission.

A.1.A. PERMANENT REMOVAL OF INCUMBENT TRUSTEES

In the event that any removal action of the Incumbent Trustees, namely Henry Haalilio Peters, Richard Sung Hong Wong, Marion Mae Lokelani Lindsey, Gerard Aulama Jervis, and Oswald Kofoad Stender, is set aside on appeal or by collateral attack and one or more of the Incumbent Trustees is reinstated as trustee of KSBE, this Closing Agreement shall be null and void in which event the procedures specified in paragraph A.1.Y.4. of this Closing Agreement will apply.

The permanent resignations of the five Incumbent Trustees have not been set aside on appeal or by collateral attack, nor have any of the five Incumbent Trustees been reinstated as a trustee of KS.

On August 24, 1999, the Interim Trustees filed a Petition for Removal of Trustees Marion Mae Lokelani Lindsey, Henry Haalilio Peters and Richard Sung Hung Wong and for Evidentiary Hearing seeking the permanent removal of three of the Incumbent Trustees. The trial on the petition was scheduled to commence in December 1999. Each of the five Incumbent Trustees resigned on a permanent basis prior to the commencement of trial, as follows:

	<u>Resignation Date</u>	<u>Date of Court Order Accepting Resignation</u>
Gerard Aulama Jervis	August 19, 1999	November 19, 1999
Oswald Kofoad Stender	September 27, 1999	January 4, 2000
Richard Sung Hung Wong	December 9, 1999	March 7, 2000
Henry Haalilio Peters	December 13, 1999	February 10, 2000
Marion Mae Lokelani Lindsey	December 16, 1999	February 1, 2000

STATUS: Completed (no further action required).

A.1.B. INCUMBENT TRUSTEES RESIGNATION FROM DIRECTORSHIPS

To the extent the Incumbent Trustees continue to hold offices, directorships, memberships, consultative relationships, perquisites, or retain ex-officio status by virtue of their prior status as Trustees of KSBE, or by virtue of KSBE's ownership, investment, control, or voting power with respect to any entity or organization, or with respect to any position within the KSBE Organizations, the Interim Trustees or their successors will seek the resignation or removal of the Incumbent Trustees from such offices, directorships, memberships, consultative relationships, perquisites, or ex-officio status immediately upon discovery of said position.

To the best of KS' knowledge, the Incumbent Trustees have either resigned or been removed from *all* positions obtained by virtue of their status as Incumbent Trustees of KS, or by virtue of KS' ownership, investment, control or voting power with respect to any entity or organization. In the event that KS subsequently discovers that an Incumbent Trustee occupies any such positions, KS will seek the resignation or removal of the Incumbent Trustee(s) from such offices, directorships, memberships, consultative relationships, perquisites, or ex-officio status immediately upon discovery of said position.

STATUS: Completed (no further action required).

A.1.C. COMMUNICATIONS AMONG TRUSTEES

[1] Any business meetings regarding KSBE Organizations' business between either the Interim Trustees or Top Executives and the Incumbent Trustees must be documented in writing by the current KSBE official in attendance at said meeting, detailing the purpose of the meeting, the substance of the matters discussed, and the persons who attended said meeting, for the term of this Closing Agreement. [2] The term "Top Executive" is defined herein as an "Organization Manager" within the meaning of IRC Section 4958(f)(2). [3] The Interim Trustee or Top Executive will notify the IRS and AG of the meeting within 30 days of said meeting. [4] The documentation of any meetings shall be available to the IRS and the AG upon request, within 30 days of said request.

[1] Any business meetings regarding KSBE Organizations' business between either the Interim Trustees or Top Executives and the Incumbent Trustees must be documented in writing by the current KSBE official in attendance at said meeting, detailing the purpose of the meeting, the substance of the matters discussed, and the persons who attended said meeting, for the term of this Closing Agreement.

All Top Executives have been notified of this requirement. All known business meetings between Top Executives and the Incumbent Trustees have been documented in writing, including all information required above.

STATUS: Ongoing.

[2] *The term “Top Executive” is defined herein as an “Organization Manager” within the meaning of IRC Section 4958(f)(2).*

Based on discussions with the IRS and Internal Audit, “Top Executive” refers to the Trustees, CEO and Chief Executives of KS, and the officers and directors of all other KS Organizations.

STATUS: No action necessary.

[3] *The Interim Trustee or Top Executive will notify the IRS and AG of the meeting within 30 days of said meeting.*

Written notification of any and all such meetings have been provided to the IRS and AG within the time period prescribed under this section.

STATUS: Ongoing.

[4] *The documentation of any meetings shall be available to the IRS and the AG upon request, within 30 days of said request.*

Documentation of such meetings have been made available to the IRS and the AG.

STATUS: Ongoing.

A.1.D. ROLE OF TRUSTEES

[1] *KSBE agrees that the Trustees shall act as fiduciaries and exercise general oversight over the activities of the KSBE Organizations, but will not be involved in management of the day-to-day operations of the KSBE Organizations. [2] The Trustees’ primary focus is the furtherance of the educational purposes of KSBE, as set forth in Attachment 5.*

[1] *KSBE agrees that the Trustees shall act as fiduciaries and exercise general oversight over the activities of the KSBE Organizations, but will not be involved in management of the day-to-day operations of the KSBE Organizations.*

Pursuant to the Governance Policy described below in Section A.1.F., the Trustees are no longer involved in the management of the day-to-day operations of KS. Effective February 1, 2000, the Interim Trustees engaged a CEO to manage the day-to-day operations of KS. With respect to the KS Organizations, the Trustees are no longer involved in the management

of the day-to-day operations of those organizations. The KS Organizations are managed by individuals who are not the Trustees of KS.

STATUS: Ongoing.

[2] *The Trustees' primary focus is the furtherance of the educational purposes of KSBE, as set forth in Attachment 5.*

Attachment 5 of the Closing Agreement is taken from the KS Governance Policy and the Trustees have acted in accordance with their duties as set forth therein.

STATUS: Ongoing.

A.1.E. SUSPENSION OR REMOVAL OF TRUSTEES

KSBE will follow the procedures established by the State of Hawai'i for suspension or removal of trustees in the event a trustee fails to fulfill his or her duties and responsibilities. KSBE agrees that in the event that a Trustee engages in one or more activities listed in Attachment 6, the other Trustees will initiate suspension or removal proceedings in accordance with Hawai'i law.

There are no known instances of any Trustees engaging in any of the activities listed in Attachment 6 of the Closing Agreement, or any other activity which would constitute grounds for suspension or removal of a Trustee. The Trustees will continue to monitor diligently each others actions. In the event that a Trustee engages in one or more activities in Attachment 6, or any other activity that would constitute grounds for suspension or removal, the other co-Trustees will initiate suspension or removal proceedings in accordance with Hawaii law. KS further asserts, as evidence of implementation of this section:

- In July 1999, the Interim Trustees requested the resignation of all five Incumbent Trustees. Trustees Jervis and Stender voluntarily resigned. Trustees Peters, Wong and Lindsey did not resign.
- On August 24, 1999, the Interim Trustees petitioned the Probate Court for the permanent removal of three remaining Incumbent Trustees in order to preserve the Trust Estate's tax exempt status. As a result, the remaining three Incumbent Trustees also submitted their resignations.
- KS' Governance Policy, revised and restated on November 22, 2000, dictates that the Board of Trustees must conduct itself in a manner which complies with all relevant laws and regulations and shall collectively perform and fulfill its duties in accordance with standards of trust laws and the Will.
- The Interim Trustees arranged for noted authorities in the area of Trust law to give presentations to the Interim Trustees, the CEO and Chief Executives on issues relating to

governance and trustee duties and obligations. Master Benjamin Matsubara attended both presentations and found them to be instructive and served to impress upon the attendees the importance of their respective roles. In finding these presentations to be beneficial, Master Matsubara recommended that future trustees of the Trust Estate, including the CEO and Chief Executives, should arrange for similar annual presentations by noted trust experts on issues relating to governance, including trustee duties and obligations, in order to be kept apprised of the latest developments relating to charitable institutions. KS has agreed to do this on an annual basis.

STATUS: Ongoing.

A.1.F. CEO MANAGEMENT STRUCTURE

[1] The management structure of KSBE will initially be organized around a Chief Executive Officer. See Attachment 7 for current structure.

[2] The Trustees will primarily establish the policies of KSBE and will exercise a fiduciary oversight role, consistent with the requirements of the Will, Probate Court orders regarding the administration of the Trust, and State of Hawai'i Trust law.

[3] The policies established by the Trustees will ensure that education is the primary focus of KSBE.

[4] The Chief Executive Officer will independently carry out the policy decisions of the Board of Trustees.

[5] KSBE agrees that the duties and responsibilities of the Chief Executive Officer are clearly defined and the individual(s) hired to fill this position will be person(s) with extensive experience in similar positions as enumerated in Attachment 8. [6] The Trustees will perform annual performance reviews of the Chief Executive Officer. [7] The CEO will review the performance of other Top Executives. [8] These performance reviews will be made available to the Internal Auditor.

[9] The IRS agrees that if, as a result of the strategic planning process described in paragraph I, an alternative management structure is recommended, the alternative management structure may be implemented by KSBE, with notice to the AG and prior approval by the Probate Court. [10] KSBE will provide the IRS with a copy of any petition seeking the Probate Court's permission to effectuate such structural or management changes. [11] KSBE will notify the IRS, in writing, of any such changes approved by the Probate Court within 30 days of issuance of the Court approval.

- [1] ***The management structure of KSBE will initially be organized around a Chief Executive Officer. See Attachment 7 for current structure.***

The management structure of KS is organized around a CEO as set forth in the KS Governance Policy approved by Court Order dated August 27, 1999, which policy was further amended by Court Orders dated June 1, 2000 and November 22, 2000. (Copies of the Court Orders and related Petitions, which included copies of the Governance Policy, were previously provided to the Masters, AG and the IRS.) Pursuant to this management structure, the CEO manages the day-to-day operations of the Trust Estate and the Trustees develop strategic policies and oversee the activities of the Trust Estate in furtherance of KS' educational purposes. Attached as Exhibit D is the current KS organization chart, approved by Court Order dated November 22, 2000.

The CEO based management system has been structured to ensure that the CEO is properly supported to manage the primary purpose of KS – education. To assist the CEO in his primary responsibilities of developing and managing the KS educational system, a Chief Education Officer (CEdO) position has been approved and will be filled within the next few months. The CEdO will be delegated the responsibilities of developing, managing and administering the KS educational system on a day-to-day basis under the supervision of the CEO. Four other Chief Executive positions that report directly to the CEO were created to support the educational purpose of KS. These include: The Chief Financial Officer (CFO) who manages the financial planning, accounting and reporting functions of KS; the Chief Investment Officer (CIO) who manages the endowment of KS; the Chief Legal Officer (CLO) who manages and coordinates all legal affairs at KS; and the Chief Administrative Officer (CAO) who coordinates and administers staff and service functions to support efficient operations at KS.

STATUS: Completed (no further action required).

- [2] ***The Trustees will primarily establish the policies of KSBE and will exercise a fiduciary oversight role, consistent with the requirements of the Will, Probate Court orders regarding the administration of the Trust, and State of Hawai'i Trust law.***

See Section A.1.D. above. In addition, the Trustees have developed and approved several policies, including, for example, policies on governance, spending, investing, conflicts of interest, anti-tampering, lobbying, procurement and delegation of authority. The Interim Trustees also reinstated the internal audit function to assist monitoring the administration and operations of the Trust Estate.

STATUS: Ongoing.

- [3] ***The policies established by the Trustees will ensure that education is the primary focus of KSBE.***

The policies established by the Trustees are designed to ensure that education is the primary focus of KS. The recently adopted Strategic Plan is being integrated with the KS Investment

Policy and Spending Policy. The Investment Policy migrates the Trust's resources toward passive investments and away from actively managed investments, other than its Hawaii core real estate. The Strategic Plan will be implemented as funds are made available through the Spending Policy. See Section A.1.K. Spending Policy.

STATUS: Ongoing.

[4] *The Chief Executive Officer will independently carry out the policy decisions of the Board of Trustees.*

The CEO carries out the policies of the Trustees and manages the day-to-day operations of KS as set forth in the Governance Policy, as amended. The CEO attends meetings of the Trustees and meets regularly with the Chairman of the Board of Trustees in order to report on the activities of the Trust Estate, seeks Trustees' approval for action, if necessary, and discusses implementation of policies. The CEO then holds weekly meetings with the Chief Executives and meets with specific Chief Executives as necessary in order to fulfill his responsibilities and carry out the policies and decisions of the Trustees.

STATUS: Ongoing.

[5] *KSBE agrees that the duties and responsibilities of the Chief Executive Officer are clearly defined and the individual(s) hired to fill this position will be person(s) with extensive experience in similar positions as enumerated in Attachment 8.*

The Interim Trustees engaged Dr. Hamilton McCubbin as the CEO of KS. Dr. McCubbin has the requisite experience and qualifications to perform the responsibilities set forth in Attachment 8 to the Closing Agreement and attached as Appendix B to the Governance Policy. Attached hereto as Exhibit C is a copy of Dr. McCubbin's resume. As a result of the Trustees' development of a policy on the delegation of authority, the Trustees have identified additional day-to-day responsibilities that the CEO is expected to perform. The CEO and Interim Trustees hired qualified individuals for the other Chief Executive positions set forth in the Governance Policy, as amended.

STATUS: Completed (Trustees to continue to monitor).

[6] *The Trustees will perform annual performance reviews of the Chief Executive Officer.*

Pursuant to the Governance Policy, the Trustees review the performance of the CEO on an annual basis for fiscal year ending June 30. The CEO's first annual review was completed and covered the short period for February 1, 2000 (hire date) to June 30, 2000.

STATUS: Completed for first annual review requirement.

[7] *The CEO will review the performance of other Top Executives.*

The CEO is responsible to review the performance of the Chief Executives on an annual basis.

STATUS: Completed for first annual review requirement.

[8] *These performance reviews will be made available to the Internal Auditor.*

The results of the Interim Trustees' annual written performance review of the CEO was and will continue to be made available to the Internal Auditor. In addition, the annual written performance reviews of the Chief Executives were and will continue to be made available to the Internal Auditor.

STATUS: Completed for first annual review requirement.

[9] *The IRS agrees that if, as a result of the strategic planning process described in paragraph I, an alternative management structure is recommended, the alternative management structure may be implemented by KSBE, with notice to the AG and prior approval by the Probate Court.*

The Interim Trustees completed a Strategic Plan (described below in Section A.1.I.), which did not result in the creation of an alternative management structure. The CEO-based management structure remains in effect at KS.

STATUS: No action necessary.

[10] *KSBE will provide the IRS with a copy of any petition seeking the Probate Court's permission to effectuate such structural or management changes.*

As described above, no petition is necessary since an alternative structure has not been adopted.

STATUS: No action necessary.

[11] *KSBE will notify the IRS, in writing, of any such changes approved by the Probate Court within 30 days of issuance of the Court approval.*

As described above, no such changes in the management structure have been adopted.

STATUS: No action necessary.

A.1.G. SYSTEM OF CHECKS, BALANCES & AFFIRMATIVE DISCLOSURE REQUIREMENTS

[1] KSBE agrees that the revised organizational structure of the KSBE Organizations referred to in paragraph F above, ensures that an adequate system of checks, balances, and affirmative disclosure requirements exists within the KSBE Organizations to provide safeguards against any abuse of power by the Trustees, individually or collectively, and any abuse of power by any Top Executives on the KSBE Organizations' staff, individually or collectively. [2] Additionally, KSBE agrees to implement an adequate system of checks, balances, and affirmative disclosure requirements to provide safeguards against the mismanagement of Trust assets by the Trustees, or by any individuals or entities given access to said assets by the KSBE Organizations. [3] The Trustees of KSBE in their capacity as Directors of any KSBE Organization will not actively participate in the day-to-day management or have effective management control over any of the KSBE Organizations. [4] The KSBE Organizations agree to submit a report to the IRS and the AG within twelve months of the date of this Closing Agreement outlining the implementation of the above stated safeguards.

[1] KSBE agrees that the revised organizational structure of the KSBE Organizations referred to in paragraph F above, ensures that an adequate system of checks, balances, and affirmative disclosure requirements exists within the KSBE Organizations to provide safeguards against any abuse of power by the Trustees, individually or collectively, and any abuse of power by any Top Executives on the KSBE Organizations' staff, individually or collectively.

In August 1999, the Interim Trustees adopted a Governance Policy as described above in Section A.1.F. The Governance Policy was developed to provide a framework within which the Board of Trustees would be guided in the execution of their fiduciary duties. It provides for a CEO-based management system in which “the Board or individual Trustees will never be engaged in the day-to-day management of the Estate, which is the responsibility of the CEO.”

STATUS: Completed (no further action required).

[2] Additionally, KSBE agrees to implement an adequate system of checks, balances, and affirmative disclosure requirements to provide safeguards against the mismanagement of Trust assets by the Trustees, or by any individuals or entities given access to said assets by the KSBE Organizations.

Since the Interim Trustees took office on May 7, 1999, there have been a number of significant policy and procedural changes implemented at KS to provide safeguards against any abuse of power by the Trustees, Top Executives or staff of KS and KS Organizations, collectively and individually, and to ensure that a system of checks, balances, and affirmative

disclosure requirements exist to establish safeguards against mismanagement of Trust assets. Most significant of these safeguards, adopted over the past year, are described below:

- Conflicts of Interest Policy. Attachment 9 of the Closing Agreement is a Conflicts of Interest Policy which was adopted by the Interim Trustees on June 24, 1999. The policy applies to the Trustees, CEO and Chief Executives and requires an annual disclosure of financial interests and external activities. A separate Conflicts of Interest Policy applies to all staff members of KS. A Conflicts of Interest Policy has been adopted by each KS Organization and requires similar annual disclosure statements of each respective Officers and Directors. All such disclosure statements are available to the AG and Master. For a more detailed discussion on this subject, see Section A.1.H. below.
- Employment Policy. The KS Organizations (that have employees) have each adopted new or stricter employment policies to ensure that employment relationships are necessary and appropriate and that compensation levels are commensurate with the services provided. For a more detailed discussion on this subject, see Section A.1.S. below.
- Re-Implementation of Internal Audit. KS re-implemented an independent Internal Audit function in February, 2000. This function provides an important and independent safeguard and internal control to ensure against any abuse of power or mismanagement by Top Executives. The Internal Auditor reports to the Audit Committee (comprised of the Trustees) and the incumbent Master and the AG are invited to attend all meetings of the Audit Committee. For a more detailed discussion on this subject, see Section A.1.O. below.
- Anti-Retaliation Policy. The KS Organizations have each adopted an Anti-Retaliation Policy to ensure that any staff member providing information to the Internal Auditor will not be subject to intimidation or detrimental retaliatory actions as a result of their activities. Any staff member having knowledge that there has been a violation of this policy is to report immediately such actions to the AG, the IRS and the Master. KS has announced this policy to all staff members of KS and KS Organizations and will do so on an annual basis. The Internal Auditor has access to all records and employees within the KS Organizations. For a more detailed discussion on this subject, see Section A.1.O.1. below.
- Anti-Tampering Policy. KS adopted an Anti-Tampering Policy which prohibits any tampering or undue influence by staff or Trustees on any internal competitive selection process. This would include, without limitation, such processes as student admissions, financial aid, scholarships, hiring, procurement of goods and services and tryouts for athletic teams. Staff members are to report promptly any attempts to tamper with such selection process to their supervisor and to the Internal Auditor. Any persons found to have tampered with a selection process will be appropriately disciplined.
- Lobbying Policy. The KS Organizations have each adopted a Lobbying Policy which includes requirements for documenting communications (which constitute lobbying) with

government officials/legislators or their assistants/associates, directors/board/ committee members or heads of governmental departments/agencies on matters relating to the financial, administrative, business or educational affairs of the KS Organizations. Training on the new policy has been completed with key KS staff members and will be provided to the KS Organizations in the coming year. For a more detailed discussion on this subject, see Section A.1.W. below.

- Prohibited Political Activities. The KS Organizations have each adopted a policy on Political Activities. The policy prohibits any political intervention as defined in IRC Section 501(c)(3) and the implementing regulations. Training on the implementation of this policy has been completed for key KS staff members and will be provided to the KS Organizations in the coming year. For a more detailed discussion on this subject, see Section A.1.V. below.
- Prohibition Against Hiring/Retaining Elected/Appointed Officials. The KS Organizations have each adopted a policy of not employing, reimbursing or paying for the services of an elected or appointed member of the legislative, judicial or executive branches of government, whether federal, state or local. This policy is important in that it safeguards against any actual, potential or perceived political intervention or payback by the KS Organizations. For a more detailed discussion of this subject, see Section A.1.T. below.
- Trustee Compensation. By Order filed May 23, 2000, the Probate Court established a new compensation structure for the Trustees. Under this new structure, the Chair of the Board of Trustees may receive a maximum of \$120,000 per year and the other Trustees a maximum of \$97,500 per year. This change in the Trustees' compensation is significant in that commissions are no longer based on a percentage of revenues or the fair market value of the Trust Estate. For a more detailed discussion on this subject, see Section A.1.L. below.
- Trustee Selection. On August 5, 1999, the Interim Trustees petitioned the Probate Court to establish a new selection procedure for future Trustees. The Court appointed a Master, Benjamin Matsubara, to review community and stakeholder-based recommendations on a screening process, and to propose a process for selection of future trustees. Master Benjamin Matsubara submitted a proposed trustee screening process, which the Probate Court subsequently approved. The process involves a court-appointed screening committee to undertake the screening and interviewing of all applicants, a set of objective criteria for selecting and screening of applicants, publication of the list of finalists, a 30-day public comment period, and a hearing on the final selection at which time the Trustees and AG would have opportunity to comment. The Screening Committee, consisting of community leaders, reviewed over 200 applications, which they narrowed down to seven finalists after extensive interviews and reference checks. From the seven finalists, the Court selected five trustees. The establishment of this procedure represents a significant change from the past trustee selection process established under the Will, which provided that "vacancies shall be filled by the choice of a majority of the Justices of the Supreme Court..." acting in their individual capacity. The past procedure had been the subject of considerable attack and criticism by commentators as being a

politicized process and pay-back for political favors. The new screening process provides an objective process and public forum for screening and selecting trustees and avoids the perception of politics and abuse.

- Business Courtesies Policy. KS adopted a Business Courtesies Policy to require disclosure by all staff members of all gifts, meals, entertainment received from persons or entities who have or maintain a business relationship with KS. The policy also prohibits staff from accepting any gifts, meals or entertainment which exceed \$50 per year. The adoption of this policy safeguards against any actual, potential or perceived undue influence or tampering with contracting for goods or services.
- Financial Controls. In addition to the items noted above, KS has established a number of additional financial controls to safeguard against mismanagement of Trust Estate assets, including, among others:
 - Establishing stringent cash disbursement guidelines requiring the CFO to sign-off and approve all payments greater than \$1,000 and the CEO sign-off and approve amounts greater than \$10,000
 - Development of a comprehensive Financial and Investment Performance Report beginning with September 30, 2000 (1st Quarter for fiscal 2001)
 - Establishment of a policy development framework, with the emphasis on developing a full set of policies that reflect KS' renewed organizational focus, aligned with the recently adopted Strategic Plan
 - Development of an enhanced budgeting process with partial implementation in fiscal 2001 for the fiscal 2002 budget, with full implementation in fiscal 2002 for the fiscal 2003 budget
- Procurement Policy. KS and KS Organizations have each adopted a Procurement Policy consistent with the guiding principles set forth in Attachment 13 of the Closing Agreement. The policy requires a competitive bid process above threshold dollar amounts and that all exceptions be approved pursuant to a system that ensures appropriate internal controls. The purpose of this policy is to ensure that the KS Organizations obtain goods and services at the most reasonable and competitive prices following best practices. For a more detailed discussion on this subject, see Section A.1.R. below.

STATUS: Ongoing.

- [3] *The Trustees of KSBE in their capacity as Directors of any KSBE Organization will not actively participate in the day-to-day management or have effective management control over any of the KSBE Organizations.*

The Governance Policy requires that "Trustees will not serve as Directors of any of the taxable subsidiaries of KS." Accordingly, no Trustee serves as an officer or director of

any taxable subsidiary. KS is in the process of establishing a Compliance Program which will include staff training on maintaining a proper arm's length with taxable subsidiaries.

STATUS: Completed (no further action required).

[4] *The KSBE Organizations agree to submit a report to the IRS and the AG within twelve months of the date of this Closing Agreement outlining the implementation of the above stated safeguards.*

KS intends that this Report constitutes the report required on the implementation of the above stated safeguards. Since this Report is also being submitted to the Masters, AG and Probate Court, it is intended to satisfy the reporting requirement to them.

STATUS: Completed (no further action required).

A.1.H. CONFLICT OF INTEREST POLICY; FINANCIAL DISCLOSURE STATEMENT

[1] *KSBE agrees that its Trustees and Top Executives are subject to a new Conflict of Interest Policy (see Attachment 9) to ensure appropriate compliance with fiduciary standards. [2] The required financial disclosure statements will be made available to the AG and to the Master.*

[1] *KSBE agrees that its Trustees and Top Executives are subject to a new Conflict of Interest Policy (see Attachment 9) to ensure appropriate compliance with fiduciary standards.*

KS adopted the Conflicts of Interest Policy included as Attachment 9 to the Closing Agreement. On April 14, 2000, KS amended its Conflicts of Interest Policy to be applicable not only to the Trustees, but also to the CEO and Chief Executives. All other KS Organizations have also adopted Conflicts of Interests Policies and related disclosure requirements, to ensure that their Top Executives adhere to the highest standards of integrity, ethics and business morals.

STATUS: Completed (no further action required).

[2] *The required financial disclosure statements will be made available to the AG and to the Master.*

Compliance with the Conflicts of Interests Policy includes annual representations and financial disclosures from the Top Executives. As of the filing of this Report, the KS Organizations received all representations and financial disclosures from these individuals.

All annual representations and financial disclosures received by the KS Organizations are available to the AG and the Master upon request.

STATUS: Completed regarding first annual requirement.

A.1.I. COMPREHENSIVE EDUCATIONAL AND STRATEGIC PLAN

[1] The KSBE Organizations have agreed to develop and implement a comprehensive educational and financial strategic plan, as ordered by the Probate Court on October 2, 1998, including investment policies. The strategic planning process will include an educational plan developed in conjunction with an investment plan, the principal focus of which is the furtherance of the educational mission of KSBE. [2] The KSBE Organizations agree that this plan will be finalized and submitted to the IRS, to the AG and the Master no later than eighteen months from the date of this Closing Agreement. [3] A copy of said plan shall also be filed by KSBE in the Probate Court.

[1] The KSBE Organizations have agreed to develop and implement a comprehensive educational and financial strategic plan, as ordered by the Probate Court on October 2, 1998, including investment policies. The strategic planning process will include an educational plan developed in conjunction with an investment plan, the principal focus of which is the furtherance of the educational mission of KSBE.

The Interim Trustees approved a comprehensive educational and financial strategic plan in September 2000 and submitted a copy of the KS Strategic Plan 2000-2015 (“Strategic Plan”) and a report on the completion and implementation of the Strategic Plan to the Probate Court on October 24, 2000. Examples of the affirmative acts taken by the Interim Trustees to implement the Strategic Plan are set forth in the Interim Trustees’ report.

STATUS: Strategic Plan completed, implementation ongoing.

[2] The KSBE Organizations agree that this plan will be finalized and submitted to the IRS, to the AG and the Master no later than eighteen months from the date of this Closing Agreement.

Under the Closing Agreement, KS is required to finalize a Strategic Plan by August 2001. As previously noted, the Strategic Plan was adopted in September 2000. The Interim Trustees made the creation of the Strategic Plan a priority as it is a vital component to the long term accomplishment of the educational mission of KS. Copies of the Strategic Plan and the Interim Trustees’ report were previously provided to the IRS, AG, and the Masters in October 2000.

STATUS: Completed (no further action required).

[3] A copy of said plan shall also be filed by KSBE in the Probate Court.

Copies of the Strategic Plan and the Interim Trustees’ report were provided to the Probate Court on October 24, 2000.

STATUS: Completed (no further action required).

A.1.J . INVESTMENT POLICY AND INVESTMENT PERFORMANCE REPORTS

[1] The Interim Trustees have adopted an initial Investment Policy. [2] KSBE agrees that its Investment Policy will be regularly updated by the KSBE Organizations, as warranted, to ensure that the investment objectives and vehicles are consistent with the educational objectives of KSBE, and [3] will be incorporated as supplemental schedules to the KSBE Organizations' financial statements. [4] Investment performance reports will be prepared and submitted by KSBE to the Probate Court with KSBE 's Annual Account. [5] Such schedules will also be provided by KSBE to the IRS during the term of this Closing Agreement. [6] A copy of said schedules shall be submitted by KSBE to the Probate Court, and to the Hawai'i Attorney General.

[1] The Interim Trustees have adopted an initial Investment Policy.

KS adopted an Investment Policy on August 18, 1999 which reflects investment objectives and vehicles consistent with KS' educational objectives. This policy was provided to the IRS as a part of the Reaffirmation Submission. No changes to the Investment Policy have been made to date.

STATUS: Completed (no further action required).

[2] KSBE agrees that its Investment Policy will be regularly updated by the KSBE Organizations, as warranted, to ensure that the investment objectives and vehicles are consistent with the educational objectives of KSBE . . .

No updates to the Investment Policy have been made to date. Because of the recent development and approval of the Strategic Plan, management will evaluate its current Investment Policy and determine if any changes are warranted.

STATUS: Progressing pursuant to the Closing Agreement.

[3] . . . will be incorporated as supplemental schedules to the KSBE Organizations' financial statements.

KS has interpreted this provision to require that investment performance reports (rather than the actual Investment Policy or updates to the Investment Policy) be included as supplemental schedules to the KS Organizations' financial statements. A Schedule of Total Return and Schedule of Trust Distributions and Spending were included as supplemental schedules to the KS Organizations' financial statements for June 30, 2000.

While not required under the Closing Agreement, additional enhanced investment reporting, monitoring and evaluation, including identifying and reporting "underperforming" investments, additional investment performance schedules, disclosure of unusually high or

low returns, review of the investment benchmarks and others, will commence with the 115th Annual Account filing (fiscal 2000) with full implementation with the filing of the 117th Annual Account filing (fiscal 2002).

STATUS: Completed with regard to June 30, 2000 financial statements.

- [4] *Investment performance reports will be prepared and submitted by KSBE to the Probate Court with KSBE's Annual Account.*

KS will submit the investment performance reports commencing with its 115th Annual Account, which KS must file with the Probate Court on or before May 15 of each year.

STATUS: Progressing pursuant to the Closing Agreement.

- [5] *Such schedules will also be provided by KSBE to the IRS during the term of this Closing Agreement.*

The schedules for June 30, 2000 are being provided to the IRS as part of this Report. See supplemental schedules to the financial statements for June 30, 2000 attached as Exhibit B.

STATUS: Completed with regard to the June 30, 2000 financial statements.

- [6] *A copy of said schedules shall be submitted by KSBE to the Probate Court, and to the Hawai'i Attorney General.*

The schedules for June 30, 2000 are being provided as part of this Report, a copy of which will be filed with the Probate Court and provided to the AG, thus satisfying this provision of the Closing Agreement.

STATUS: Progressing pursuant to the Closing Agreement.

A.1.K. SPENDING POLICY

[1] *KSBE and the KSBE Organizations have developed and agree to follow a spending policy that focuses on the educational purpose of KSBE, as set forth in Attachment 10.*
[2] *The IRS agrees that KSBE may increase spending to directly serve the educational needs of children consistent with the Will and Probate Court orders regarding the administration of the Trust.* [3] *At least annually, KSBE will publicly solicit written comments from the Hawaiian community concerning the developmental and educational needs of native Hawaiian children.*

- [1] *KSBE and the KSBE Organizations have developed and agree to follow a spending policy that focuses on the educational purpose of KSBE, as set forth in Attachment 10.*

KS adopted a Spending Policy on August 18, 1999, included as Attachment 10 to the Closing Agreement. This Spending Policy has not been changed or amended since its adoption.

As disclosed in the audited financial statements for June 30, 2000 the Spending Policy targets annual trust distributions at 4% of the average market value of the endowment plus the net income (loss) generated from KS' Agriculture and Conservation lands. The Spending Policy also provides for actual trust distributions to vary annually in a range of 2.5 to 6%. Since this is a newly adopted policy, KS anticipates that it will take time to increase trust distributions responsibly to the targeted 4% level. Beginning with fiscal year 2000, a Schedule of Trust Distributions and Spending is provided as part of the supplemental schedules to KS' financial statements. These supplemental schedules are subject to auditing procedures by KS' independent external auditor. The Schedule of Trust Distributions and Spending reflects a spending rate for fiscal year June 30, 2000 of 2.76%.

KS plans to expand the reporting as it relates to the Spending Policy to include: (1) a schedule showing the computation of the annual target spending amount, based on the average market value of the Trust Estate's Endowment, (2) a schedule showing the comparison of the actual spending amount with the targeted spending amount, with an explanation of significant variances, and (3) a schedule showing the actual and projected spending amount over the most recent 5-year period. This new reporting will commence with the 116th Annual Accounts filing (fiscal 2001) for items (1) and (2) and will commence with the 120th Annual Accounts filing (fiscal 2005) for item (3).

STATUS: Completed with regard to June 30, 2000 financial statements. Full implementation ongoing.

- [2] *The IRS agrees that KSBE may increase spending to directly serve the educational needs of children consistent with the Will and Probate Court orders regarding the administration of the Trust.*

Pursuant to the Strategic Plan, KS contemplates expanding existing and creating new programs consistent with the intention to increase spending for educational purposes in future years.

STATUS: Progressing pursuant to Closing Agreement.

- [3] *At least annually, KSBE will publicly solicit written comments from the Hawaiian community concerning the developmental and educational needs of native Hawaiian children.*

As part of the strategic planning process, a wide spectrum of KS staff members and individuals in the Hawaiian community provided input concerning the developmental and educational needs of native Hawaiian children. These individuals included teachers and administrators, asset managers and attorneys, neighbor islanders and O'ahu residents, alumni and students, parents of current beneficiaries and of potential beneficiaries, staff of Hawaiian organizations and members of the larger community.

KS plans to annually solicit written comments from the Hawaiian community concerning the developmental and educational needs of native Hawaiian children. This will be done through a combination of written and/or telephone surveys, and requests for comments in the annual newspaper publication of KS' inventory of property and in KS' Annual Report.

STATUS: Completed for fiscal year 2000. Ongoing.

A.1.L. TRUSTEE COMPENSATION COMMITTEE

KSBE agrees that it will comply with the program approved by the Probate Court for setting Trustee compensation. See Attachment 11.

The Probate Court entered an Order on May 23, 2000 (effective February 1, 2000), in which the Court approved the recommendation of the Independent Compensation Committee on the compensation to be paid to the Trustees. The Independent Compensation Committee recommended in their Report filed in the Probate Court on October 1, 1999, that each Trustee be paid \$30,000 per year, plus \$2,000 per meeting of the Board of Trustees or any committee thereof for the chair of the Board of Trustees and \$1,500 per meeting of the Board of Trustees or any committee thereof for each Trustee other than the chair; provided, that the additional compensation for meetings shall be limited to a maximum of 45 meetings per 12-month period. The May 23, 2000 Order further provided that the Trustees could be reimbursed for reasonable business-related expenses, but that the Trustees shall be treated as independent contractors and not employees. The Trustees are not eligible to receive fringe-benefits typically provided to employees and receive no other form of compensation from KS Organizations.

Within the next year, in accordance with Attachment 11 to the Closing Agreement, the Trustees will submit a Ruling Request to the IRS for approval of the method determining the Trustees' compensation for future years.

STATUS: Progressing pursuant to the Closing Agreement.

A.1.M. CEO COMPENSATION

KSBE agrees to follow the methodology for determining the compensation of the Chief Executive Officer, as set forth in Attachment 12.

The compensation of the CEO was set by the Interim Trustees in consultation with an independent nationally recognized compensation consultant, Strategic Compensation Associates ("SCA"). SCA provided benchmarks of executive compensation for not-for-profit organizations, private foundations, as well as market pay data for presidents of the National Association of Independent Schools and small private colleges. Based upon this information, and good faith negotiations with the CEO candidate, in January 2000 the Interim Trustees set the annual compensation for the CEO, who commenced employment at KS on February 1, 2000. For the first year of employment, from February 1, 2000 to January 31, 2001, the CEO will receive an annual salary of \$300,000. For the second and third years of employment (i.e., February 1, 2001

to January 31, 2002 and February 1, 2002 to January 31, 2003), the CEO will receive an annual salary of \$350,000. In addition, the CEO is provided with a residential dwelling, an automobile leased by KS, moving expenses, membership at a luncheon club and other employee benefits comparable to those available to all KS employees. There is no incentive or other bonus plan for the CEO.

STATUS: Completed (no further action required).

A.1.N. AUDITED FINANCIAL STATEMENTS

[1] The KSBE Organizations will ensure that certified financial audits are prepared and filed annually with the Probate Court with the Annual Accounts of the KSBE Organizations. [2] For the term of this Closing Agreement, these financial statements, including all supplemental schedules, will also be provided to the IRS, to the Hawai'i Attorney General, and [3] made available to the general public upon request and by posting them on KSBE's Internet Web-site. [4] These statements will be prepared in conformity with GAAP, unless otherwise approved in Court Orders and Stipulations by the Probate Court.

[1] The KSBE Organizations will ensure that certified financial audits are prepared and filed annually with the Probate Court with the Annual Accounts of the KSBE Organizations.

The KS Organizations have engaged independent CPA firms as external auditors to opine on the fair presentation of the respective audited financial statements and supplemental schedules. The financial statements for June 30, 2000 will be filed with KS' annual filing with the Probate Court of its Annual Account for the June 30, 2000 year-end, which will be filed on or before May 15, 2001.

STATUS: Progressing pursuant to the Closing Agreement.

[2] For the term of this Closing Agreement, these financial statements, including all supplemental schedules, will also be provided to the IRS, to the Hawai'i Attorney General . . .

The audited financial statements and supplemental schedules are attached to this Report as Exhibit B. Since a copy of this Report will be provided to the AG, the requirements of this section will be satisfied.

STATUS: Completed with regard to the June 30, 2000 year end.

[3] . . . and made available to the general public upon request and by posting them on KSBE's Internet Web-site.

KS will also make available the audited financial statements for fiscal year end 2000 to the public by posting them on KS' website and by providing copies to members of the public

who request copies. For fiscal year end 1999, KS made its audited financial statements available through its publication of an Annual Report which was mailed out to parents, alumni, staff members, stakeholders, members of the Hawaiian community and made available to the public upon request.

STATUS: Progressing pursuant to Closing Agreement.

[4] *These statements will be prepared in conformity with GAAP, unless otherwise approved in Court Orders and Stipulations by the Probate Court.*

Audited financial statements and supplemental schedules have been and will continue to be prepared in accordance with GAAP.

STATUS: Completed with regard to June 30, 2000 year end.

A.1.O. INTERNAL AUDITOR FUNCTION & RELATED POLICIES & PRIVILEGES

[1] *An independent internal audit function has been reimplemented within KSBE, as described in Attachment 8. [2] In addition to its other functions, the independent Internal Auditor including the Auditor's staff members (hereinafter "Internal Auditor") will monitor the KSBE Organizations' compliance with the terms of this Closing Agreement, all Court orders and stipulations relevant to this Agreement, and adherence to the Conflict of Interest Policy set forth in Attachment 9. [3] The Internal Auditor will annually report the results of his/her monitoring of KSBE's compliance with this Closing Agreement, all Court orders and stipulations relevant to this Agreement, and adherence to the Conflict of Interest Policy to the IRS as "Special Filings" during the term of this Closing Agreement. [4] The Special Filings will be signed by the Internal Auditor under the penalties of perjury. [5] The Special Filings will also be submitted by KSBE to the Master, and the Attorney General of the State of Hawai'i.*

[6] *The KSBE Organizations have established procedures to ensure that the Internal Auditor and any individuals within the KSBE Organizations providing information to the Internal Auditor will not be subject to intimidation, or detrimental or retaliatory actions as a result of their activities. [7] Such protections will be announced and affirmed in a resolution of the Board of Trustees and communicated to all employees on an annual basis. [8] The Internal Auditor or any other employee having knowledge that there has been a violation of this policy shall immediately report to the AG, the IRS and the Master any actions that violate this policy by KSBE, its Trustees, the KSBE Organizations, and their agents and employees.*

[9] *The Internal Auditor will have immediate and unrestricted access to all records irrespective of their physical form and will be able to interview all employees of KSBE*

and the KSBE Organizations at the Auditor's request. [10] The attorney/client privilege and/or other privileges will not be asserted by KSBE or the KSBE Organizations to prevent disclosure of any records to the Internal Auditor or access to any individuals by the Internal Auditor.

[11] The Internal Auditor will be paid an annual salary set by the Board of Trustees, and [12] may be removed or reassigned only for just cause by a majority of the Board of Trustees;

[13] In the event the Internal Auditor finds that a trustee or Top Executive has failed to comply with the Conflict of Interest policy, the Internal Auditor will report any apparent conflicts to the Board of Trustees for appropriate action. [14] The Board of Trustees will communicate in writing to the Internal Auditor the action or actions resulting from the Internal Auditor's report to the Board of Trustees, within 30 days of the action. [15] The Internal Auditor will also include in the Special Filing provided for in Paragraph O, above, the actions taken by the Board of Trustees, if any, in response to the Internal Auditor's report to the Board of Trustees of an apparent or actual conflict of interest.

[1] An independent internal audit function has been reimplemented within KSBE, as described in Attachment 8.

On or about the time that the Closing Agreement was executed, KS reestablished the function of Internal Audit within KS. The Internal Audit function has the following primary objectives (as set forth in the Governance Policy):

- The terms of the Will of Bernice Pauahi Bishop are fulfilled in perpetuity
- The assets of the Trust Estate are properly safeguarded and used primarily for educational purposes.
- Policies and procedures established by the Board of Trustees are being adhered to by the Trust Estate.
- Compliance with applicable state and federal laws and regulations.
- Compliance with the terms of the Closing Agreement is monitored and maintained throughout the duration of the Closing Agreement.

On February 15, 2000, the Interim Trustees executed an agreement, as amended, with the Honolulu office of Arthur Andersen LLP ("Andersen" or "AA") to provide Internal Audit services beginning February 15, 2000 ("Andersen Agreement"). Prior to execution, the Andersen Agreement was submitted to the IRS. The Internal Audit function will start to be transitioned to internal staff members after 18 months.

The Andersen Agreement further clarifies that it is KS' responsibility to establish and maintain an effective internal control system, recordkeeping, management, decision-making and other management functions. Internal Audit Services do not include or substitute for management's responsibilities.

STATUS: Completed (no further action required).

[2] *In addition to its other functions, the independent Internal Auditor including the Auditor's staff members (hereinafter "Internal Auditor") will monitor the KSBE Organizations' compliance with the terms of this Closing Agreement, all Court orders and stipulations relevant to this Agreement, and adherence to the Conflict of Interest Policy set forth in Attachment 9.*

Internal Audit continually monitors the KS Organizations' compliance with the terms of the Closing Agreement, all Court orders and stipulations relevant to the Closing Agreement, and adherence to the Conflict of Interest Policy. Such monitoring is accomplished through:

- Discussions with management on matters of interpretation
- Attendance at monthly Closing Agreement status meetings, conducted by management
- Reviewing policies and performing compliance tests across the KS Organizations to ensure adherence to the specific terms of the Closing Agreement
- Assisting KS in developing this Report to fulfill reporting requirements
- Obtaining Conflict of Interest representations and disclosures from Top Executives to ensure compliance with the Conflict of Interest Policies

STATUS: Ongoing.

[3] *The Internal Auditor will annually report the results of his/her monitoring of KSBE's compliance with this Closing Agreement, all Court orders and stipulations relevant to this Agreement, and adherence to the Conflict of Interest Policy to the IRS as "Special Filings" during the term of this Closing Agreement.*

Concurrent with the filing of this Report, the Internal Auditor will submit to the IRS the Special Filing with regard to the monitoring of KS' compliance with the Closing Agreement, all Court orders and stipulations relevant to the Closing Agreement, and adherence to the Conflict of Interest Policy.

STATUS: Completed for the first year.

[4] *The Special Filings will be signed by the Internal Auditor under the penalties of perjury.*

The Special Filing is signed by the Internal Auditor, currently Arthur Andersen, under penalties of perjury.

STATUS: Completed for the first year.

- [5] *The Special Filings will also be submitted by KSBE to the Master, and the Attorney General of the State of Hawai'i.*

The Special Filing will be submitted to the Master and the AG contemporaneous with the date of submission to the IRS.

STATUS: Completed for the first year.

- [6] *The KSBE Organizations have established procedures to ensure that the Internal Auditor and any individuals within the KSBE Organizations providing information to the Internal Auditor will not be subject to intimidation, or detrimental or retaliatory actions as a result of their activities.*

As further discussed in Section A.1.G., KS Organizations adopted and implemented an Anti-Retaliation Policy that ensures the Internal Auditor and any individuals within the KS Organizations providing information to the Internal Auditor will not be subject to intimidation, or detrimental or retaliatory actions as a result of their activities. KS Organizations have established procedures for reporting violations of this policy through a prescribed form to the Internal Auditor. In addition, this information may also be directly reported to the AG, IRS and/or the Court-Appointed Master.

STATUS: Completed for the first year.

- [7] *Such protections will be announced and affirmed in a resolution of the Board of Trustees and communicated to all employees on an annual basis.*

The Anti-Retaliation Policy was announced and affirmed by the Interim Trustees pursuant to a resolution on June 29, 2000. All KS Organizations also have adopted this policy. The policy was communicated to employees of all KS organizations on July 24, 2000 by written correspondence from the CEO. KS Organizations intend to communicate the policy organization-wide to all employees annually.

STATUS: Completed for first requirement year .

- [8] *The Internal Auditor or any other employee having knowledge that there has been a violation of this policy shall immediately report to the AG, the IRS and the Master any actions that violate this policy by KSBE, its Trustees, the KSBE Organizations, and their agents and employees.*

There have been no known violations of this Anti-Retaliation Policy.

STATUS: Ongoing.

- [9] *The Internal Auditor will have immediate and unrestricted access to all records irrespective of their physical form and will be able to interview all employees of KSBE and the KSBE Organizations at the Auditor's request.*

The Internal Auditor has been and will continue to be provided immediate and unrestricted access to all records, as well as the ability to interview all employees of the KS Organizations at the Auditor's request.

STATUS: Ongoing.

- [10] ***The attorney/client privilege and/or other privileges will not be asserted by KSBE or the KSBE Organizations to prevent disclosure of any records to the Internal Auditor or access to any individuals by the Internal Auditor.***

Attorney/client privilege and/or other privileges have not been and will not be asserted by the KS Organizations to prevent disclosure of any records to the Internal Auditor, or access to any individuals by the Internal Auditor. The Internal Auditor has been allowed access to all records and employees of the KS Organizations.

STATUS: Ongoing.

- [11] ***The Internal Auditor will be paid an annual salary set by the Board of Trustees . . .***

As provided in the Andersen Agreement submitted to the IRS and entered into on behalf of KS by the Interim Trustees, the current annual salary for the Internal Auditor is in the form of a consulting fee based on a blended rate per hour.

STATUS: Ongoing.

- [12] ***. . . may be removed or reassigned only for just cause by a majority of the Board of Trustees;***

KS decided that the most beneficial and efficient means to re-implement the internal audit function was to enter into an outsourcing arrangement. As is true with many outsourcing arrangements and as further defined in the Andersen Agreement, KS has the right to terminate the arrangement at any time, with or without cause, upon 30 days prior written notice. If termination is without cause, KS is required to pay AA a termination fee pursuant to the Andersen Agreement. Once KS fills the Internal Audit position with an individual employee as opposed to an outsourcing arrangement, KS intends that such employee will not be removed or reassigned unless for just cause by a majority of the Trustees.

STATUS: Ongoing.

- [13] ***In the event the Internal Auditor finds that a trustee or Top Executive has failed to comply with the Conflict of Interest policy, the Internal Auditor will report any apparent conflicts to the Board of Trustees for appropriate action.***

There have been no known violations of the Conflict of Interest Policy by Top Executives. Section A.1.H. discusses compliance with the Conflict of Interest Policy in greater detail.

STATUS: Ongoing.

[14] *The Board of Trustees will communicate in writing to the Internal Auditor the action or actions resulting from the Internal Auditor’s report to the Board of Trustees, within 30 days of the action.*

Since no known violations have occurred, no such report has been required.

STATUS: Ongoing.

[15] *The Internal Auditor will also include in the Special Filing provided for in Paragraph O, above, the actions taken by the Board of Trustees, if any, in response to the Internal Auditor’s report to the Board of Trustees of an apparent or actual conflict of interest.*

Since no known violations have occurred, no such report has been required.

STATUS: Ongoing.

A.1.P. REVIEW OF CONTRACTUAL RELATIONSHIPS

[1] *KSBE has undertaken a review of existing contractual, consultative, employment, and professional service relationships in existence as of June 30, 1999 to ensure that the services provided under such contracts or through such relationships are necessary to the operation of the KSBE Organizations, that the prices and/or compensation paid for such services are reasonable and commensurate with services rendered, and that they are not in violation of any of the terms of this Closing Agreement. [2] Retainer fees were subject to special scrutiny for propriety. [3] KSBE shall report the results of this review to the IRS, the Master, and the AG within twelve months of the date of this Closing Agreement. [4] A copy of said report shall also be filed with the Probate Court.*

[1] *KSBE has undertaken a review of existing contractual, consultative, employment, and professional service relationships in existence as of June 30, 1999 to ensure that the services provided under such contracts or through such relationships are necessary to the operation of the KSBE Organizations, that the prices and/or compensation paid for such services are reasonable and commensurate with services rendered, and that they are not in violation of any of the terms of this Closing Agreement.*

KS Organizations performed an extensive review of contractual, consultative and professional service relationships in existence as of June 30, 1999, to ensure that the services provided under such contracts or through such relationships are necessary to the operation of KS Organizations, that the prices and/or compensation paid for such services are reasonable and commensurate with services rendered, and that they are not in violation of any of the terms of the Closing Agreement.

“Violation of any of the terms of the Closing Agreement” was interpreted by KS to represent a violation of the Conflict of Interest Policy with respect to “Top Executives” (as defined in

A.1.C.) and the employment and retention of appointed or elected government officials as described in Section A.1.T.

KS Organizations identified vendors where contractual relationships existed as of June 30, 1999. Lists of those vendors to whom the KS Organizations had paid over \$1,000 during fiscal years 1999 and 2000 were provided to Internal Audit for their review. From the latter vendor list, Internal Audit selected contractual relationships based on (1) amounts greater than \$25,000, (2) contracts identified by management as being influenced by the Incumbent Trustees or members of management, and (3) judgmental and random selections, which included a significant number of vendors that were paid less than \$25,000. Internal Audit provided the list of vendors that it selected for review based on the foregoing criteria to the KS Organizations with a request to answer the following questions:

- What was the nature of goods/services provided?
- Was there a contract? Was the contract put out for bid?
- Were the goods/services necessary to the operations of the entity?
- Were prices paid reasonable and commensurate with what was provided?
- Were there any known conflict of interest violations with respect to engaging this vendor?
- If conflicts existed, what was management's course of action taken to resolve the issue?

Responses were subject to Internal Audit's review and testing. A total of approximately 1,300 contractual/consultative and professional service relationships were evaluated as part of this review.

The following is a summary of findings resulting from the review:

- All significant contractual relationships (including retainer agreements) identified as being either unnecessary, where prices were not reasonable or commensurate with services rendered or where retention was possibly in violation of Conflicts of Interest (with respect to the Incumbent Trustees) were terminated or discontinued prior to the review.
- There were no ongoing significant improper contractual relationships identified during the review.
- Issues raised by Internal Audit were brought to the attention of the affected KS Organizations for further evaluation and/or consideration and steps have been taken to resolve issues identified.
- Vendors identified during the IRS Audit were given heightened scrutiny and steps have been taken to ensure that any such alleged improprieties of the past are discontinued.

- In connection with this extensive review, several procurement issues were identified which are discussed further at Section A.1.R.

STATUS: Completed (no further action required).

[2] *Retainer fees were subject to special scrutiny for propriety.*

During the review, retainer fees were subject to special scrutiny for propriety and all inappropriate retainer fees were terminated.

STATUS: Completed (no further action required).

[3] *KSBE shall report the results of this review to the IRS, the Master, and the AG within twelve months of the date of this Closing Agreement.*

KS intends that this Report constitutes the report required on the results of the review of service relationships to the IRS. Since this Report is also being submitted to the Master and the AG, it is intended to satisfy the requirement to report on the results of KS' review of service relationships.

STATUS: Completed (no further action required).

[4] *A copy of said report shall also be filed with the Probate Court.*

Since this Report is also being filed with the Probate Court, it is intended to satisfy the requirement to report on the results of KS' review of service relationships.

STATUS: Completed (no further action required).

A.1.Q. REVIEW OF SIGNIFICANT JOB CLASSIFICATIONS

[1] *KSBE and the KSBE Organizations have reviewed all significant job classifications in existence as of June 30, 1999 to ensure that the job positions and compensation for such positions are appropriate for the accomplishment of KSBE's exempt purpose and that the individuals occupying such positions are qualified to perform the responsibilities of the position. [2] KSBE shall report the results of this review to the IRS, the Master, and the AG within twelve months of the date of this Closing Agreement. [3] A copy of said report shall also be filed with the Probate Court.*

[1] *KSBE and the KSBE Organizations have reviewed all significant job classifications in existence as of June 30, 1999 to ensure that the job positions and compensation for such positions are appropriate for the accomplishment of KSBE's exempt purpose and that the individuals occupying such positions are qualified to perform the responsibilities of the position.*

KS Organizations performed a review of all significant job classifications in existence as of June 30, 1999 to ensure that the job positions and compensation for such positions are appropriate for the accomplishment of KS' exempt purpose and that the individuals occupying such positions are qualified to perform the responsibilities of the position.

“Significant job classifications” were interpreted to include the following:

- KS – Principal Executives and Senior Management (terms used as of June 30, 1999)
- Pauahi Management Company (PMC) - President, Vice President of Finance and General Counsel
- Kamehameha Investment Company (KIC) - President and Vice President (vacant)
- KUKUI, Inc. and KUKUI Operating Company - President

Also included in the position review were selected employees whose employment management determined was influenced by one or more of the Incumbent Trustees.

Standard questions were created for purposes of this evaluation:

- Is the position necessary to the Organization's mission?
- Is the individual qualified for the position?
- Is compensation commensurate with experience?

Responses were subject to Internal Audit's review.

The following summarizes the results of the position review:

KS

- KS' Human Resources Director conducted a review of 42 positions, of which 26 positions were senior management and above and 16 positions were filled by individuals whose hiring was influenced by an Incumbent Trustee.
- Of the 26 Senior Management and above positions, one exception was noted, and appropriate action is being taken.
- Of the 16 positions identified as influenced by an Incumbent Trustee, one exception was noted and the position was eliminated.
- While all other influenced positions met the three standards noted above, 6 positions were eliminated.

KS Organizations (with Employees)

- Each KS Organization conducted its review consistent with the standard questions as noted above.
- For all subsidiaries excluding PMC, no exceptions were noted.

- PMC’s evaluation resulted in one position being deemed not necessary to the organization’s mission and another position where compensation was not commensurate with job responsibilities. Management has taken action to resolve these issues.
- The Director of Internal Audit interviewed the outside Directors of each subsidiary, to understand the process and objectivity for evaluating the position of the President.

STATUS: Completed (no further action required).

[2] *KSBE shall report the results of this review to the IRS, the Master, and the AG within twelve months of the date of this Closing Agreement.*

KS intends that this Report constitutes the report required on the results of the review of significant job classifications to the IRS. Since this document is also being submitted to the Master and the AG, it is intended to satisfy the requirement to report on the results of KS’ review of significant job classifications.

STATUS: Completed (no further action required).

[3] *A copy of said report shall also be filed with the Probate Court.*

Since this Report is also being submitted to the Probate Court, it is intended to satisfy the requirement to report on the results of KS’ review of significant job classifications.

STATUS: Completed (no further action required).

A.1.R. PROCUREMENT POLICY

KSBE and the KSBE Organizations agree to follow their standard procurement practices policy, attached as Attachment 13, to ensure that contracts for goods and services will be awarded on the basis of open and competitive bidding, and that exceptions to competitive bidding will be specifically defined, as set forth in Attachment 13.

KS Organizations have agreed to follow their standard procurement practices policy under guidelines set forth in the “KS and KS Organizations Procurement Guiding Principles,” Attachment 13 to the Closing Agreement. Each KS Organization adopted its own Procurement Policy consistent with the Guiding Principles, to ensure that contracts for goods and services will be awarded on the basis of open and competitive bidding, and that exceptions to competitive bidding will be specifically defined.

Implementation of the policy throughout the KS Organizations is in process, as effective communications of the policy, as well as efficient implementation continue to be a challenge. KS Organizations have identified, in part, based on Internal Audit’s reviews conducted under Section A.1.P., that certain contract vendor files lack the appropriate documentation that is

required under the standard procurement policy, and exceptions to the bidding process are, at times, not adequately documented nor justified.

Significant efforts to transition into full compliance with the standard procurement policies are underway. For example:

- KS hired a Purchasing Manager, who is responsible for the training program and for migrating towards coordinating a centralized procurement function.
- KS held a training seminar with the Purchasing Department staff discussing the importance of the procurement policy and the purchasing function, staff's role in implementation of the policy, policy enforcement and the performance measures that will be incorporated into staff's evaluation.
- KS Organizations instituted a procurement training program to educate individuals who are actively involved in the procurement process to ensure awareness and proper execution.
- For added internal control at KS, the CFO currently approves all cash disbursements greater than \$1,000 and the CEO reviews and approves all disbursements greater than \$10,000 to mitigate risk of improprieties.
- KS is also evaluating the feasibility of migrating towards electronic procurement, or "e-procurement."
- To the extent practicable, KS Organizations have utilized best practice guidelines to assist in procurement implementation, and have developed formal checklists covering purchasing procedures and pre-approval of vendors.

STATUS: Progressing pursuant to the Closing Agreement.

A.1.S. EMPLOYMENT AND CONTRACT POLICIES AND PROCEDURES

[1] KSBE and the KSBE Organizations will establish employment and contractual procedures ensuring, prospectively, that contractual and employment relationships are necessary and appropriate and that the prices and/or compensation paid for services are reasonable. [2] A report of said procedures shall be submitted by KSBE to the IRS and the AG within twelve months of the date of this Closing Agreement. [3] A copy of said report shall be filed by KSBE with the Probate Court.

[1] KSBE and the KSBE Organizations will establish employment and contractual procedures ensuring, prospectively, that contractual and employment relationships are necessary and appropriate and that the prices and/or compensation paid for services are reasonable.

KS' employment procedures, including both documentation of the reason for a request for hire and a process for position evaluation to ensure that compensation is reasonable, is as follows:

- Three standard KS forms have been revised to assist supervisors in considering various options to meet operational requirements, and in performing assessments for filling vacant positions or requesting temporary hires.
- Modifications to KS' Employment Practices Policy will assist supervisors with guidelines for performing personnel assessments.
- KS' Position Evaluation Policy assures that compensation paid to employees is reasonable and commensurate with the position.
- Effective September 2000, all requests to hire using the standard KS personnel form must be submitted to the CEO for final review and approval.

The KS Organizations have adopted policies consistent with the policy adopted by KS. Procedures for contractual relationships are covered under the Procurement Policy. For a more detailed discussion on this subject, see Section A.1.R.

STATUS: Completed (no further action required).

[2] *A report of said procedures shall be submitted by KSBE to the IRS and the AG within twelve months of the date of this Closing Agreement.*

KS intends that this Report constitute the report required to the IRS on established employment and contractual procedures. Since this Report is being submitted to the AG, the requirement to submit this Report to the AG will be satisfied.

STATUS: Completed (no further action required).

[3] *A copy of said report shall be filed by KSBE with the Probate Court.*

Since this document is also being submitted to the Probate Court, it is intended to satisfy the requirement to report on the establishment of employment and contractual procedures.

STATUS: Completed (no further action required).

A.1.T. EMPLOYMENT OF GOVERNMENT OFFICIALS

[1] *KSBE and the KSBE Organizations agree that they will follow the policy of not employing, reimbursing, or paying for the services of (including office expenses of), an elected or appointed member of the legislative, judicial, or executive branches of government, whether state, federal, or local. (This provision does not apply to non-compensated positions on advisory commissions or boards unless service on such a*

board or commission would violate KSBE's Conflict of Interest policy.) [2] In no case shall KSBE or the KSBE Organizations employ such an individual, until a period of three years has passed since the individual's status as an appointee or elected official with the governmental entity has terminated, unless KSBE has received the express approval of the Probate Court. [3] Notwithstanding the above, Robert Herkes, an incumbent legislator employed by KSBE may serve the remainder of his term in the Hawaii legislature which expires November, 2000, but will not thereafter serve in the legislature while employed by KSBE or the KSBE Organizations and will otherwise be subject to the foregoing paragraph.

[1] KSBE and the KSBE Organizations agree that they will follow the policy of not employing, reimbursing, or paying for the services of (including office expenses of), an elected or appointed member of the legislative, judicial, or executive branches of government, whether state, federal, or local. (This provision does not apply to non-compensated positions on advisory commissions or boards unless service on such a board or commission would violate KSBE's Conflict of Interest policy.)

The KS Organizations have adopted and implemented a stringent policy applicable to all employees which addresses the continued employment, reimbursement, or payment for services of persons who seek or become an elected or appointed member of the legislative, judicial, or executive branches of government, whether state, federal, or local. The pertinent provisions of KS' policy (which policy has been adopted by the KS Organizations in substantially similar terms) provide as follows:

- It is the policy of KS to not employ, reimburse, or pay for services of (including office expenses of), an elected or appointed member of the legislative, judicial, or executive branches of government, whether state, federal or local. (This provision does not apply to non-compensated positions on advisory commissions or boards unless service on such a board or commission creates an actual or potential conflict of interest with KS.) In no case shall KS employ such an individual, until a period of three (3) years has passed since the individual's status as an appointee or elected official with the governmental entity has terminated, unless KS has received the express approval of the Probate Court.
- If an employee accepts a position on a public commission or board, or registers to run for public office, employment will be terminated. This provision does not apply to non-compensated positions on advisory commissions or boards unless service on such a board or commission creates an actual or potential conflict of interest with KS. In all cases the employee must notify his or her supervisor prior to accepting such position or registering to run for public office.

The KS Organizations agree that all employment, reimbursement and service payment situations covered by their respective policy will be resolved in a manner that is consistent with the terms of the policy and applicable law.

No known elected or appointed member of the legislative, judicial, or executive branches of government, whether state, federal or local, is currently employed, receiving reimbursements, or receiving payments for services by the KS Organizations.

STATUS: Ongoing.

[2] *In no case shall KSBE or the KSBE Organizations employ such an individual, until a period of three years has passed since the individual's status as an appointee or elected official with the governmental entity has terminated, unless KSBE has received the express approval of the Probate Court.*

KS does not employ, reimburse, or pay for services of (including office expenses of), an elected or appointed member of the legislative, judicial, or executive branch of government, whether state, federal or local, unless a period of 3 years has passed since the individual's status as an appointee or elected official with the governmental entity has terminated.

STATUS: Ongoing.

[3] *Notwithstanding the above, Robert Herkes, an incumbent legislator employed by KSBE may serve the remainder of his term in the Hawaii legislature which expires November, 2000, but will not thereafter serve in the legislature while employed by KSBE or the KSBE Organizations and will otherwise be subject to the foregoing paragraph.*

This provision of the Closing Agreement has been satisfied.

STATUS: Completed (no further action required).

A.1.U. DOCUMENTATION OF TRUSTEE AND TOP EXECUTIVE DECISIONS

[1] *The KSBE Organizations have established procedures which will ensure the proper and complete documentation of all educational, investment and management decisions made by the Board of Trustees and by the Top Executives, and retention of said documentation. [2] The Board of Trustees' minutes will contain documentation to indicate the Trustees present at the meeting and will contain a record of the matters voted on, in addition to the acceptance or rejection of the particular matter. [3] Any staff reports presented prior to or during a meeting of the Board will be attached and filed with the appropriate minutes. [4] Any Resolutions passed will be attached and filed with the appropriate minutes. [5] In all instances in which these documents concern matters relating to the administration of the Trust, or a Trustee's fiduciary obligations or duties, or the Trustees' fiduciary responsibilities as Trustees, these documents will be readily available upon request for inspection and copying by IRS personnel, by the Hawai'i Attorney General's office, as parens patriae, or by the Probate Court, without assertion of privileges.*

- [1] *The KSBE Organizations have established procedures which will ensure the proper and complete documentation of all educational, investment and management decisions made by the Board of Trustees and by the Top Executives, and retention of said documentation.*

Management of KS Organizations have strengthened the procedures and guidelines to ensure that there is proper and complete documentation and retention of all educational, investment and management decisions made by the Top Executives.

STATUS: Completed (no further action required).

- [2] *The Board of Trustees' minutes will contain documentation to indicate the Trustees present at the meeting and will contain a record of the matters voted on, in addition to the acceptance or rejection of the particular matter.*

The Trustees' meeting minutes indicate the individuals present, including Trustees, Chief Executives, staff, guests and the designated meeting secretary.

Decisions voted on, as provided in the minutes, indicate acceptance or rejection of the particular matter, including whether or not there was unanimous approval. Dissenting votes are also indicated in the minutes.

STATUS: Ongoing.

- [3] *Any staff reports presented prior to or during a meeting of the Board will be attached and filed with the appropriate minutes.*

Staff reports presented to the Trustees to facilitate discussion and to aid with the decision making process have been and will continue to be attached and filed with the respective minutes.

STATUS: Ongoing.

- [4] *Any Resolutions passed will be attached and filed with the appropriate minutes.*

Resolutions have been and will continue to be attached and filed with the respective minutes.

STATUS: Ongoing.

- [5] *In all instances in which these documents concern matters relating to the administration of the Trust, or a Trustee's fiduciary obligations or duties, or the Trustees' fiduciary responsibilities as Trustees, these documents will be readily available upon request for inspection and copying by IRS personnel, by the Hawai'i Attorney General's office, as parens patriae, or by the Probate Court, without assertion of privileges.*

All of the minutes from the Trustees' meetings and related staff reports relating to the administration of the Trust Estate, or a Trustee's fiduciary obligations or duties, or the

Trustees' fiduciary responsibility as Trustees, are available upon request for inspection and copying by IRS, the AG, or the Probate Court, without assertion of privileges consistent with Court Orders.

STATUS: Ongoing.

A.1.V. PROHIBITED POLITICAL INTERVENTION POLICY

The KSBE Organizations will not engage in any prohibited political intervention, as defined in the IRC Section 501(c)(3) and the implementing Regulations.

KS has not engaged in any prohibited political intervention. KS previously adopted a Political Activities Policy which prohibits participation in or intervention in any political campaign on behalf (or in opposition to) any candidate for public office. The policy was re-evaluated for its applicability during this reporting period. This policy is consistent with the requirements of an "action organization" as set forth in IRC Section 501(c)(3).

Although this policy applies to the tax-exempt subsidiaries of KS under IRC Section 501(c)(3), KS has elected to apply this requirement to all KS Organizations, who have adopted similar policies prohibiting political intervention.

There have been no known instances of any violations of this policy with respect to KS and KS Organizations.

STATUS: Ongoing.

A.1.W. LOBBYING POLICY

[1] KSBE agrees that within 6 months of the date of this Closing Agreement, KSBE will adopt a lobbying policy that will include requirements for documenting communications with state and federal legislators, legislative offices and committees on matters relating to the financial, administrative, business, or educational affairs of KSBE or the KSBE Organizations. [2] Documentation of any such communications will be made available to the Master, the AG, and the IRS.

[1] KSBE agrees that within 6 months of the date of this Closing Agreement, KSBE will adopt a lobbying policy that will include requirements for documenting communications with state and federal legislators, legislative offices and committees on matters relating to the financial, administrative, business, or educational affairs of KSBE or the KSBE Organizations.

In December 1999, KS adopted a Lobbying Policy, which was subsequently amended in August 2000, to provide that:

- The highest level of ethical standards is maintained
- Thorough and accurate records of all lobbying activities and expenses are maintained through detailed documentation
- Compliance with reporting requirements

The policy also establishes a Lobbying Compliance Committee to guide the focus of the Organization’s lobbying efforts. The Committee is made up of the CEO, Chief Executives and staff members from various departments.

In addition, KS instituted a lobbying and political intervention training program to educate and inform key staff members who are or may be potentially engaged in lobbying activities. This program was designed to ensure organization-wide compliance as part of the policy implementation plan.

Although IRS lobbying requirements apply to tax-exempt organizations under IRC Section 501(c)(3), all KS Organizations have adopted lobbying policies similar to that adopted by KS.

STATUS: Completed (no further action required).

[2] *Documentation of any such communications will be made available to the Master, the AG, and the IRS.*

The documentation generated under the Lobbying Policy is available to the Master, the AG, and the IRS upon request.

STATUS: Ongoing.

A.1.X. CONTROLLING INTEREST

[1] *Any entity in which KSBE has or acquires an ownership interest of more than 50 percent, or any controlling interest in any organization, whether taxable or tax exempt, shall be considered a part of the KSBE Organizations for purposes of this Agreement. This includes any subsidiary or related organization organized under foreign law. Any passive investments, for example a passive investment in a limited partnership, will not be considered a part of the KSBE Organizations for purposes of this Closing Agreement, with the following exceptions:*

[2] *Any compensation paid to Trustees or Top Executives by an entity that is involved in a passive investment of KSBE or the KSBE Organizations must be reported to the IRS and the AG in the annual Internal Auditor’s Special Filing referenced in Paragraph O of this Closing Agreement;*

[3] Any passive investments must be included in the FMV of the Trust Endowment for purposes of the annual Trust Spending Rate.

[1] Any entity in which KSBE has or acquires an ownership interest of more than 50 percent, or any controlling interest in any organization, whether taxable or tax exempt, shall be considered a part of the KSBE Organizations for purposes of this Agreement. This includes any subsidiary or related organization organized under foreign law. Any passive investments, for example a passive investment in a limited partnership, will not be considered a part of the KSBE Organizations for purposes of this Closing Agreement, with the following exceptions:

Subsequent to the Effective Date, KS has added three other entities to the list of KS Organizations. These include:

1. Konia, Inc. This is a Delaware for-profit corporation wholly-owned by KS, established in 1994 for the purpose of investing in securities and other business investments.
2. Sino Finance Group LLC. This is a Delaware limited liability company established in 1995 for the purpose of holding an equity interest in Xiamen International Bank in the People's Republic of China.
3. Keauhou Kona Resort Company. This is a Hawaii general partnership established in 1981 for the purpose of investing in real estate. Kamehameha Investment Corporation (KIC) is a 75% general partner, and Paki, Inc. is a 25% general partner. Both KIC and Paki, Inc. are included as KS Organizations.

See Exhibit A for a complete list of the KS Organizations.

The three entities noted are included within the definition of the KS Organizations for purposes of the Closing Agreement and this Report.

STATUS: Ongoing.

[2] Any compensation paid to Trustees or Top Executives by an entity that is involved in a passive investment of KSBE or the KSBE Organizations must be reported to the IRS and the AG in the annual Internal Auditor's Special Filing referenced in Paragraph O of this Closing Agreement;

No Trustees or Top Executives have received compensation from an entity that is involved in a passive investment of KS or KS Organizations.

STATUS: Ongoing.

[3] Any passive investments must be included in the FMV of the Trust Endowment for purposes of the annual Trust Spending Rate.

All of the Endowment Assets of the KS Organizations, including all passive investments, have been included in determining the FMV of the Endowment for purposes of calculating the annual Trust Spending Rate.

STATUS: Ongoing.

B.1. SETTLEMENT OF TAX AND UBIT ISSUES

KSBE agrees to a settlement of Nine Million Dollars for payment in lieu of Federal taxes or deficiencies thereof, additions to tax, and penalties for the tax years ended June 30, 1992, through June 30, 1996. KSBE agrees to a payment of Four Million Nine Hundred Ninety-Two Thousand, Five Hundred Dollars (\$4,992,500) for interest on the above stated settlement, calculated as of the date of execution of this Closing Agreement. This settlement includes the tax liability with respect to the “credit enhancements issue” through June 30, 1998. The “credit enhancements issue” relates to all fees paid or accrued during 1997 and 1998 under agreements similar in nature to those in issue in the Forms 5701 Issue No. B-IA and Issue No. B-IC, by which KSBE agreed to extend its creditworthiness to third parties, such arrangements including, but not limited to, note repurchase agreements, securing letters of credit, and otherwise providing guarantees of payment. This settlement amount will be paid in full within five working days of the date on which this Closing Agreement is executed. Payment will be by wire transfer to an account to be specified by the IRS.

KS paid the settlement amount of \$9,000,000 plus interest in the amount of \$4,992,500 for a total of \$13,992,500 by check no. B169501 made payable to the Internal Revenue Service on December 30, 1999.

STATUS: Completed (no further action required).

C.2. CLOSING AGREEMENT AVAILABLE TO THE PUBLIC

This Closing Agreement and Attachments will be made available to the public by KSBE in the KSBE Office located at Kawaiaha’o Plaza, 567 South King Street, Suite 200, Honolulu, Hawai’i, 96813, and on the KSBE Internet Web-site upon the signing of said Agreement.

On September 8, 1999, KS made available on its Internet website (www.ksbe.edu) a copy of the Closing Agreement with attachments. KS also made available on its website its Reaffirmation Submission (added to the website on September 8, 1999) and the letter dated February 23, 2000,

from the IRS reaffirming KS' tax-exempt status (added to the website on April 4, 2000). The Closing Agreement and the other documents remain posted and available for public inspection on KS' website and are available at the KS offices located at 567 South King Street, Honolulu, Hawaii 96813.

STATUS: Completed (no further action required).

CONCLUSION

The statements made in this Report are true and correct to the best of my knowledge.

Respectfully submitted:

KAMEHAMEHA SCHOOLS

Dated: February 22, 2001

By _____
Hamilton I. McCubbin
Chief Executive Officer