

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
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TABLE OF CONTENTS

BACKGROUND.....2

MISSION.....5

VISION.....6

ORGANIZATIONAL GOALS.....6

EDUCATION PROGRAMS AND SERVICES.....8

 Current Educational Programs.....8

 Publishing.....10

 The Future.....10

STRATEGIC PLANNING.....12

 Request for Proposals.....12

SPENDING AND INVESTMENT POLICY.....14

 Development of an Interim Comprehensive Spending Policy.....14

 Investment Planning.....15

GOVERNANCE.....19

 Selection of Trustees.....19

 Role of Trustee/Organizational Structure.....21

 Trustee Compensation.....25

FINANCIAL REPORTING & INTERNAL CONTROLS.....28

 Internal Audit Function.....28

 Financial Statements.....34

 Investment Schedules.....34

 Employment and Contractual Relationships.....35

 Procurement Practices.....36

BACKGROUND

Kamehameha Schools Bernice Pauahi Bishop Estate (“KSBE”) was created in 1884 pursuant to the Last Will and Testament and Codicils (the “Will”) of Ke Ali’i Bernice Pauahi Bishop, the last direct descendant of Hawai’i’s royal Kamehameha line (see the Will attached as

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

Exhibit A). In her Will, Princess Pauahi set forth that her inheritance be used “to erect and maintain in the Hawaiian Islands two schools, each for boarding and day scholars, one for boys and one for girls to be known as, and called the Kamehameha Schools.”

Under the auspices of the Will, the Kamehameha School for Boys first opened October 3, 1887 with thirty-four students. Seven years later, on December 19, 1894, the Kamehameha Schools for Girls began operating with twenty-seven students.

Through the decades, what began as two separate schools is now one of the largest private schools in the United States and provides a variety of educational opportunities. Today, KSBE educates approximately 4,000 students every year.

On February 2, 1939, the IRS determined that KSBE was a tax-exempt organization under Section 101(6) of the Revenue Act of 1938 (predecessor to IRC Section 501(c)(3)), which the IRS reconfirmed by a letter dated November 28, 1952. Additionally, the IRS determined that KSBE was an educational organization under IRC Section 501(c)(3) on April 16, 1969. On September 10, 1986, the IRS reconfirmed KSBE as an exclusively charitable trust under Section 501(c)(3) of the Internal Revenue Code and as an educational institution under Sections 509(a)(1) and 170(b)(1)(A)(ii) of the Internal Revenue Code, respectively.

For over one hundred years, the Kamehameha Schools have continuously provided quality education to descendants of Hawaiian ancestry (see the technical advice memorandum regarding KSBE’s admissions policy attached as Exhibit B). In those years, approximately 17,000 students have graduated from the Kamehameha Schools.

FINAL VERSION
August 18, 1999

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

The educational purpose of KSBE is articulated in its Mission and Vision Statements. These Statements will help guide future Trustees in their effort to provide a quality education to children of Hawaiian ancestry.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

MISSION

Kamehameha Schools Bishop Estate exists to carry out in perpetuity the wishes of Ke Ali'i Bernice Pauahi Bishop to educate children and youth of Hawaiian ancestry to become good and industrious men and women. This Mission will be accomplished through the Kamehameha Schools as resources permit.

To accomplish this Mission KSBE will:

- ❑ Promote the educational development and growth of all people at KSBE;
- ❑ Foster Protestant religious worship, morals and spiritual values;
- ❑ Prudently and actively manage assets to meet our educational goals;
- ❑ Conduct ourselves with a clear commitment to *po'okela* – excellence;
- ❑ Encourage, cultivate and inspire students, graduates and staff to serve the Hawaiian community and the community at large;
- ❑ Preserve and perpetuate Hawaiian culture, traditions and values;
- ❑ Instill throughout the organization Hawaiian ancestral values including: *Pono* – To be moral and proper; *'Imi 'Ike* – To seek Knowledge; *Laulima* – To work cooperatively; *Lokomaika'i* – To share; *Na'au Pono* – To possess a deep sense of justice; *Malama* – To care for each other; and *Ha'aha'a* – To be humble.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

VISION

To carry out in perpetuity the wishes of Ke Ali'i Bernice Pauahi Bishop to educate children and youth of Hawaiian ancestry to become good and industrious men and women, the Kamehameha Schools Bishop Estate embraces as its Vision for KSBE the following 3 R's of Educational Responsibility:

Reach. The Trustees of KSBE commit themselves to expanding the reach of KSBE educational resources to children and youth of Hawaiian ancestry through the prudent management of assets, planned increases in enrollment in existing programs and selective new programs, and through the use of new teaching and telecommunications technologies. The staff of KSBE commit themselves to assist the Trustees in achieving the educational goals and objectives of KSBE.

Readiness. The administration, faculty and staff of Kamehameha Schools Bernice Pauahi Estate commit themselves to readying children and youth of Hawaiian ancestry to become good and industrious men and women through a planned program of high quality and cost-effective educational services.

Return. The alumni and students of Kamehameha Schools commit themselves to returning to the Hawaiian community through their leadership and service some of the benefits they have received from their association with Kamehameha Schools.

ORGANIZATIONAL GOALS

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

Understanding the tasks required of all at KSBE to insure the successful implementation of the Will of Ke Ali'i Pauahi will be reflected in KSBE's statement of Goals. Although to be developed as a part of the strategic planning process described below, these Goals will be designed as organizational goals that will be used to shape both the current strategic planning activity, and subsequent operational planning endeavors. These Goals will be reviewed by the executive staff of KSBE who are the individuals who will participate in the development of the Goals and the development of appropriate strategic objectives. The strategic objectives will be specific, time-limited, measurable and achievable. The timetables and strategies for accomplishing these objectives will be detailed in a series of KSBE operational plans that will be developed based on the strategic plan.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

EDUCATION PROGRAMS AND SERVICES

Current Educational Programs

Kapalama Campus: On its central Kapalama Height Campus (“Kapalama Campus”), located on six hundred acres of land in Honolulu, KSBE operates the Kamehameha Elementary School and Kamehameha Secondary School (“Kamehameha Schools”). A preschool is also located on the Kapalama Campus.

The Kamehameha Elementary School curriculum is designed to prepare children for a challenging college preparatory education at the Kamehameha Secondary School (“Secondary School”). The curriculum emphasizes development of the whole child through academics, social skills, the arts, culture and physical education. Additional activities foster cultural awareness and promote social, emotional and spiritual development.

The Secondary School is a college preparatory school for Hawaiian students. The student body numbers approximately 2,500 in grades seven through twelve. In addition to classrooms and laboratories, the Secondary School includes two learning centers, a television studio, a performing arts complex, athletic facilities and a chapel. There are also dormitories for about five hundred boarding students.

The academic program at the Secondary School is rigorous. Extensive offerings in the academic areas (e.g., English, science) as well as performing and visual arts and health and fitness, challenge students and prepare them for the future. In addition, an honors program with advanced placement courses in all major subject areas is offered to the academically talented students. The Secondary School also offers its students a wide range of

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

extracurricular activities and special opportunities outside Hawai'i, such as the Student Exchange Program and the Summer Talent Search Program.

Approximately four hundred and fifty students graduate from the Secondary School annually. Over ninety percent of Kamehameha graduates continue their education at institutions of higher learning, including such schools as Harvard, Stanford, Princeton and Columbia. Kamehameha graduates are among the ranks of doctors, engineers, business and government leaders and other professionals throughout the United States and the world.

Additional Educational Facilities: In line with its vision of expanding KSBE's educational resources to children and youth of Hawaiian ancestry, KSBE has started elementary schools on each of the islands of Maui and Hawai'i. Additionally, KSBE operates family-based education centers that include preschool programs throughout the State of Hawai'i.

Outreach Programs and Preschools: On June 17, 1999, the Trustees unanimously moved to establish an expansive educational outreach program and expand the reach of KSBE's preschools. Several important steps are part of this directive including the addition of preschool instruction for three-year-olds (previously limited to four-year-olds); the establishment of a new Kamehameha Schools' partnership with the State Department of Education; and the development of a new Kamehameha parent-infant educational program. State and Kamehameha School officials have noted that this program will have a significant effect on the education of children throughout Hawai'i.

Summer Programs: Campus Day Programs and Campus Boarding Programs are two summer programs operated by KSBE. These programs include Summer School, Performing

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

Arts Academy, Summer Science Institute, Ho'omaka'ika'i Explorations, Kamehameha Computer Camp, Kulia i Ka Pono, and International Studies Institute.

Publishing

Kamehameha Schools Press is the educational publishing arm of KSBE. In the beginning years of Kamehameha Schools, students learned printing as a craft, producing publications such as newspapers and manuals.

The first book identified as a Kamehameha Schools Press publication was published in 1933 and entitled, "Ancient Hawaiian Civilization." During the next twenty-five years Kamehameha Schools Press produced many other classic books on Hawai'i. However, in-house printing of books ended when Kamehameha Schools' curriculum shifted away from vocational and towards college preparatory in the 1960s.

Responding to the needs of teachers at the institution and the community at large for specialized materials, Kamehameha Schools Press now regularly issues new publications. Such publications include reference books on Hawaiian history, adult- and student-level biographies of key figures in Hawaiian history, collections of Hawaiian folklore and curriculum materials for the teaching of Hawaiian history and studies at various grade levels. One of the Kamehameha Schools Press's newest efforts is the re-issuing of biographical and folklore titles in modern Hawaiian translations, thus supporting and leading the contemporary revitalization of Hawaiian as a living spoken language.

The Future

KSBE's commitment to education will increase in the next hundred years. The Trustees are embarking on a number of initiatives that will expand educational opportunities for children

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

of Hawaiian ancestry (for example, the outreach and preschool programs discussed above). In order to better identify programs that will serve the Trustees' goal of "touching as many of the beneficiaries" as possible, a strategic planning process is being undertaken.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

STRATEGIC PLANNING

Request for Proposals

On October 2, 1998, sixteen stipulations involving recommendations for KSBE and its accounts were filed in the First Circuit Court of the State of Hawai'i (the "Probate Court"). In accordance with Stipulations No. 5 and 13, on June 15, 1999 the Probate Court approved a stipulation for a request for proposals ("RFP") in connection with KSBE's strategic planning (Exhibit C). The RFP has been issued by KSBE and responses have been received.

The RFP states that the strategic planning project will include the development of an educational plan in conjunction with a detailed spending plan, which in turn, will be supported by an investment plan. The educational plan will take into account the future potential of the financial resources of KSBE including all assets held by its taxable subsidiaries and tax-exempt affiliates, including Kamehameha Activities Association ("KAA") (hereinafter the term "KSBE Organizations" refers to KSBE, its subsidiary and supporting organizations including, without limitation, KAA and Bishop Holdings Corporation and the term "KSBE" refers to the Trust Estate). The spending plan (see discussion below) will be refined to meet projected educational program needs. The principal focus of this interrelated planning process is the furtherance of the educational mission of KSBE.

KSBE has received four proposals out of the eleven consulting firms solicited. After examination of these proposals, the Trustees will select a nationally known consultant to assist in KSBE's strategic planning. The RFP sets forth that work on the project will commence no later than thirty days from the date the strategic planning firm is engaged. The comprehensive educational and financial strategic plan and recommended governance

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

structure to implement such plans must be completed and delivered to KSBE within twelve months from the date of engagement of the firm.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

SPENDING AND INVESTMENT POLICY

Cambridge Associates has been engaged to assist KSBE in developing new integrated investment and spending policies consistent with the new and expanded educational program needs that are being identified and developed, in conjunction with the strategic planning process discussed above. These policies have been developed to ensure that the investment and spending policies are consistent with the educational objectives of KSBE and will be implemented as described below.

Development of an Interim Comprehensive Spending Policy

As part of KSBE's efforts to further its educational purposes, new and expanded educational program needs are already being identified and developed. It is anticipated that additional programs will be identified for consideration. A sustainable Spending Policy based upon a "Financial Equilibrium" concept (Exhibit D), developed with the assistance of Cambridge Associates, has been adopted. As provided by the Spending Policy, the target rate for expenditures on educational programming is 4 percent (the endowment spending rate) of the average market value of the investment assets (as modified as described below) of KSBE and the KSBE Organizations. With respect to fluctuations in the spending rate, KSBE will make every effort to ensure that actual spending will not fall below 2_ percent or exceed 6 percent of the average market value of included assets.

This Spending Policy has been developed taking into consideration several factors including the specific nature of assets of KSBE and the KSBE Organizations. For instance, when targeting the percentage of assets to be spent, certain assets may not be considered. As an example, the Schools and the assets used directly in educational programming will be

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

excluded. Another example of excluded assets is the Hawaiian real estate classified as agricultural and conservation land. However, although the agricultural and conservation land is excluded from the calculation of KSBE's spending rate, the net income from this land (revenue less management and upkeep costs) will be spent on educational program expenses.

The Spending Policy represents the efforts of KSBE to further its tax-exempt purpose and its dedication to educational endeavors. The Spending Policy takes into consideration and addresses several items including the fact that KSBE is a perpetual trust, KSBE and the KSBE Organizations are the dominant source of revenues for KSBE (as opposed to gifts or donations), a need to moderate the volatility of investment markets exists, and KSBE needs flexibility in preparation for significant expansion of programs and changes in investment strategy. Under the provisions of the Spending Policy, investment related expenses are not included within the purview of the endowment spending rate. Rather, investment expenses are to be charged against the investment return of KSBE and the KSBE Organizations.

Once implemented, the educational program expenditures will be compared to the spending thresholds calculated pursuant to the Spending Policy. To the extent excess funding is available, additional program opportunities will be identified. If there is a shortfall, through the budgeting process KSBE will determine whether endowment or other assets, such as those of a subsidiary or an affiliate, should be liquidated in order to fund educational programs.

Investment Planning

The long term financial objective of KSBE and the KSBE Organizations is to provide a perpetual source of revenue to fund the organization's educational programs. In order to achieve this financial objective, KSBE and the KSBE Organizations should attain an average annual real return (as described below) equal to 5 percent (net of investment related

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

expenses). Thus, the long-term Investment Objective of KSBE and the KSBE Organizations is this 5 percent average annual real return percentage.

A comprehensive initial Investment Policy supporting the expanded educational mission of KSBE while maintaining financial stability has been developed with the assistance of Cambridge Associates and adopted by KSBE (Exhibit E). This includes an asset allocation strategy that, while recognizing the unique character of KSBE's Hawaiian real estate holdings, is designed to support the expanded program service needs, maintenance of KSBE's physical facilities, and the perpetual nature of the endowment. Further, the Investment Policy takes into consideration several competing objectives including the need for moderation of the volatility of the market value of KSBE and the KSBE Organizations in order to provide a stable and growing source of support as well as the need to maintain adequate levels of liquidity to meet spending requirements and maintain diversification. The Investment Policy balances the need for predictable cash flow and the desire to maximize the return on endowment assets.

The assets affected by the Investment Policy include KSBE's and the KSBE Organizations' long-term investment assets ("Endowment Fund"). However, the Endowment Fund does not currently include agricultural and conservation land holdings or reserve funds of KSBE and the KSBE Organizations.

Management will be charged by the Board of Trustees to execute the Investment Policy. With the assistance of Cambridge Associates, current investments will be analyzed against the Investment Policy and the asset allocation strategy to assess the long-term "fit" of each investment into KSBE's overall plan. As appropriate, prudent exit strategies for selected investments will be developed.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

KSBE has two general categories of assets, Core Assets consisting of Hawaiian real estate and other non-core investment assets. The Investment Policy provides for the use of established and institutional quality third-party investment managers for the majority of non-core assets. Along with other implementation guidelines, KSBE will establish policies for each managed portfolio in order to ensure that its marketable stock portfolios, in aggregate, are well diversified.

The Investment Policy provides for a formal review of the Investment Policy at least every five years with the assistance of a nationally recognized investment consulting firm, in order to assess the continued appropriateness of the Investment Policy. Included within this review will be a determination whether all or some of the agricultural land should be included in the Endowment Fund. The Investment Policy also provides for the continuous evaluation and adjustment to investment policies as necessary between formal reviews. Further, KSBE will undertake a comprehensive review of the Investment Policy in conjunction with the overall strategic planning process to ensure the investment objectives and vehicles are consistent with the educational objectives of KSBE.

With input from Cambridge Associates, proposed policies and procedures have been developed to review investment performance annually. The Special Master is reviewing these policies and procedures with the assistance of Arthur Andersen. KSBE has agreed in Stipulation No. 8 (Exhibit F), that investment return will be analyzed against appropriate benchmarks, which have been established as part of the proposed policies and procedures. Establishment of benchmarks is critical to the long-term performance of an institution's investment program. If benchmarks are to be meaningful they must reflect the true purpose of the fund, be realistically achievable in the investment markets, be clearly quantifiable and

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

incorporate a stated time horizon. As is typically done by large endowments, KSBE will use two sets of benchmarks; 1) a long-term benchmark for the total fund that reflects its financial objectives and 2) shorter-term benchmarks that compare fund results with current market returns. Also in accordance with Stipulation No.8, KSBE will annually prepare benchmarked investment performance schedules. The schedules shall be audited and attached to the annual financial statements submitted to the Probate Court with annual accounts of the Trustees (Exhibit L).

Under Stipulation No. 9 (Exhibit F), investment return analyses will be done utilizing measures such as time weighed return and/or internal rate of return to allow for meaningful comparisons. These calculations will be compared to the benchmarks identified above for purposes of evaluating an investment's performance and its ongoing place in the portfolios of KSBE and the KSBE Organizations.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

GOVERNANCE

Selection of Trustees

The Will of Bernice Pauahi Bishop provides that KSBE shall have five trustees and, furthermore, that the trustees be selected by the Justices of the Supreme Court of Hawai'i. Four of the five current Supreme Court Justices have stated that they will no longer make appointments. Currently, it appears that the Probate Court has jurisdiction over the Trustee selection process. The Interim Trustees have filed a petition with the Probate Court containing a Recommendation for Trustee Selection Process ("Recommendation"), which sets out a proposed selection process for Trustees. Although the selection process may change after review by the Court, it is expected that the Court, in the exercise of its statutory and inherent powers, will adopt this or a similar process to provide for the selection and appointment of future Trustees.

The Recommendation (Exhibit G) contains several provisions regarding Trustee selection, including the Court appointment of a Trustee Selection Committee ("Committee"). Service on the Committee would be voluntary and members of the Committee would serve without pay from either KSBE or the Court. Under provisions of the Recommendation, the Committee would represent a diversity of interests and backgrounds such as the students' parents, the alumni of the Schools, the Hawaiian community, and the community-at-large. Further, the Committee would be composed of individuals qualified to fulfill the Committee's responsibilities. Additionally, in order to ensure their independence, the Recommendation imposes a disclosure requirement on Committee members in the event that a conflict of interest occurs between a member and an applicant for the position of Trustee.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

Under provisions of the Recommendation, the Committee is charged with the task of screening potential candidates for Trustee and ensuring that any final candidate meets the qualifications to sit as a Trustee. Once the Committee has identified its top candidates, the names will be submitted to the Probate Court. The Court will appoint a nominee from that list or reject the list for cause and return the matter to the Committee for further nominations.

The Recommendation also contains a discussion of identified criteria and qualifications for a Trustee. In drafting the Recommendation, KSBE anticipated that the Probate Court would examine qualifications for serving as Trustee based on role and new organizational structure (see discussion below). As such, the Recommendation provides that a potential Trustee must have expertise in strategic planning and policy, business administration, finance and investment, or other general areas of interest such as education, law, governance or finance. The desired qualities or characteristics of a Trustee include a demonstrated reputation of integrity, the capacity to fulfill the responsibilities of a fiduciary under trust law, a commitment to the best interests of children, consistent and active leadership in the community-at-large, and a willingness and sincerity to uphold the purposes of KSBE.

In order to ensure the integrity of the Board of Trustees, the Recommendation also provides that the Trustees be subject to term limits. The applicable provisions state that a Trustee should serve a standard term of five years. At the end of the term, the Trustee may re-apply. The Committee could consider the Trustee for reappointment, along with other eligible candidates for the open Trustee position. Additionally, the Recommendation provides for a maximum service of two terms, with a recommendation to the Court for staggered terms in the event more than one trustee must be selected at a time.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

Role of Trustee/Organizational Structure

The Trustees have adopted a “Governance Policy” (“Policy”) which clearly defines the duties and responsibilities of the Trustees/Board (a copy of the Policy is attached as Exhibit H). The Policy provides:

The Trustees’ role is to create, sustain, and fulfill a vision whose primary focus is on furtherance of education, while leaving the development and execution of the plan to fulfill the vision to the Chief Executive Officer (CEO). **The Board sets policy; management implements policy; the Board is responsible for oversight of the Estate while the day-to-day management of the operations of the Estate is the responsibility of the CEO.** [emphasis supplied]

This definition is based on the specific acknowledgment included in the Policy preamble that “KSBE is a perpetual, charitable trust estate established for exclusively educational purposes, namely, ‘to erect and maintain...the Kamehameha Schools.’ All activities of KSBE must be consistent with and in furtherance of this primary purpose.” In committing to governing KSBE “...through a continually improved commitment to its vision, mission and values” the Board is ensuring that the role of Trustee is now clearly defined with a primary focus on the furtherance of the educational mission of the KSBE.

As part of the Trustees’ clearly defined role, the Policy provides that the Trustees are to be fiduciaries who serve to exercise oversight over KSBE. Further, as previously stated, the Policy provides that the Trustees will not be involved in management of the day-to-day operations of KSBE. Rather, the Trustees will primarily establish the policies of KSBE, including ensuring that education is KSBE’s primary focus.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

The Policy sets forth the organizational structure (See Exhibit I) of KSBE that has been agreed upon as a current approach to implementing Stipulation No. 14, part of the sixteen stipulations filed with the Probate Court on October 2, 1999 (see Exhibit F). Under this structure, a CEO will independently carry out the Policy decisions of the Trustees. The Board of Trustees will “[s]elect, regularly evaluate, fix the compensation of, and where appropriate, hire or replace the CEO of KSBE.” The CEO is then “authorized to establish all further relevant administrative regulations, make all decisions, take all actions necessary to attain the goals and objectives of the Board, establish all practices and coordinate all new or expansions of programs.” Certain day-to-day operations of the School will be led by the President of the School who reports directly to the CEO.

Also included in the Policy adopted is a specific provision entitled “Manner of Governing.” Again, this policy requires the Board to maintain an oversight role. The policy requires the Board to “[e]nforce upon itself whatever discipline is needed to govern with excellence. Discipline will apply to matters such as attendance, policymaking principles, [and] respect of roles....” It further provides that the Board will “[m]onitor and discuss the Board’s process and performance at least quarterly. Self-monitoring will include comparison of Board activity and discipline to policies in the Governance process and Board-CEO/President Relationship categories.”

The organizational structure of KSBE and the KSBE Organizations ensures that an adequate system of checks, balances, and affirmative disclosure requirements exists within KSBE and the KSBE Organizations to provide safeguards against any abuse of power by the Trustees, individually or collectively, and any abuse of power by any senior managers on the staff of KSBE or the KSBE Organizations, individually or collectively. Additionally, there will be an

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

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 KSBE or the KSBE Organizations.

The overall Governance Policy highlights the high fiduciary obligations of the Trustees and includes a Board of Trustees' Code of Conduct. The Trustees also have adopted a detailed Conflict of Interest Policy (see Exhibit J) as required by Stipulation No. 16 (see Exhibit F). This Conflict of Interest Policy applies equally to officers and key employees.

With respect to resignation or removal of a Trustee, the 'Forward' of the Policy states that "if for any reason a Trustee cannot fulfill or has violated his/her fiduciary duties and obligations, he or she, without hesitation, must voluntarily and loyally resign as a Trustee." In addition, a Trustee is subject to the laws of the State of Hawai'i including Hawai'i Revised Statutes (HRS) Section 560:7-201 which provides for the removal of a trustee for cause by the Circuit Courts of the State of Hawai'i. Removal is warranted if the court concludes that allowing a trustee to continue office would be detrimental to the estate. Grounds for removal of a trustee include, but are not limited to, the following:

- Incapacity;
- Unfitness;
- Extreme personal improvidence, insolvency, or bankruptcy;
- Commission of a serious crime, especially one involving dishonesty;
- Misconduct evidencing moral turpitude or abuse of office;
- Knowing failure to obey a court order;
- Knowing failure to comply with law and regulation applicable to the trust estate;
- Knowing failure to render complete and accurate accounts;
- Knowing misrepresentation of the affairs of the trust estate;

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

- Disobedience to the directions and terms of the trust instrument;
- Failure to act appropriately in the affairs of the trust;
- Activity detrimental to the obvious best interest of the trust;
- Neglect of the office of trustee;
- Unreasonable or corrupt failure to cooperate with co-trustees;
- Failure to respond in a timely and reasonable manner to reasonable requests of the court appointed master or the Attorney General as *parens patriae* for information concerning the affairs of the trust estate;
- Mismanagement of the trust estate;
- Commingling trust and personal funds;
- Acquiring a personal interest adverse to the trust;
- Self-dealing;
- Permitting or accepting any degree of private inurement;
- Failure to disclose known conflicts of interest;
- Failure to abstain from any involvement in transactions in which the trustee has a conflict of interest;
- Appropriation of trust property to personal use;
- Making unauthorized dispositions of trust property;
- Waste of trust assets;
- Activities which jeopardize the tax exempt status of the trust estate;
- Activities which expose the trust estate or its subsidiaries to significant civil or criminal penalties and forfeitures; and
- Willful and wanton abuse of discretion.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

A trustee whose removal is sought has a fiduciary duty to assess the allegations against him or her. If it is clear that the allegations are substantially accurate and continued service would be detrimental to the estate, the trustee should resign.

With respect to documentation of the oversight function of the Board of Trustees, KSBE has established procedures which will ensure the proper and complete documentation and retention of all educational, investment and management decisions made by the Board of Trustees as well as key employees. 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. Any staff reports presented will be attached and filed with the appropriate minutes.

Trustee Compensation

A Probate Court approved program for setting Trustee compensation has been established as well as a system for monitoring compliance with that system (see Probate Court Order dated May 10, 1999 at Exhibit K), with the participation of KSBE, the Master and the Attorney General (see Stipulation No. 15 attached as Exhibit F).

Under the compensation plan ("Plan"), the Probate Court shall periodically appoint a committee to determine the compensation of the Trustees of KSBE ("Compensation Committee"). Pursuant to the Order, the Compensation Committee must consist of "knowledgeable and informed persons, each of whom the Court finds to possess the integrity,

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

probity, competence and disinterested status necessary to be qualified and serve as an independent and unconflicted Committee member under applicable IRS regulations.”

The sole purpose of the Compensation Committee is the determination of what constitutes a reasonable amount of annual compensation to be paid to each of the Trustees of KSBE. The Probate Court Order (“Order”) allows the Compensation Committee to “commission an independent compensation survey from a national, independent, professional consulting firm active in the field of executive and trustee compensation.” The Order further provides that the survey must be based on “functionally comparable positions.”

Based on the study (or studies) commissioned, the Compensation Committee will report its determination of reasonable Trustee compensation which may be expressed as a range or an amount up to a specified limit. The determination may provide for differing levels of compensation for individual Trustees based upon any considerations determined to be appropriate under state and federal law and regulations. The Compensation Committee’s report must include an explanation of the basis for its determination and must be accompanied by copies of all documents referred to in its report.

The Probate Court will schedule a hearing regarding the determination rendered by the Compensation Committee and then may approve, disapprove or modify the recommendation. If the Probate Court modifies the recommendation, the Judge is required to do so in a manner “consistent with applicable provisions of state and federal law and regulations with the object of assuring that the compensation paid the KSBE Trustees is reasonable within the meaning of both state and federal law and regulations.”

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

After the CEO is in place and following an appropriate transition period, KSBE will submit a Ruling Request to the IRS seeking approval for a method for determining Trustee compensation going forward.

The Compensation Committee shall be reasonably compensated for its services with the compensation to be fixed by the Court. No amount of the compensation will be paid to the Compensation Committee for its services until a recommendation has been provided to the Court.

On May 10, 1999, the Probate Court appointed the initial Compensation Committee. The Trustees have provided the Compensation Committee with a copy of the Governance Policy that has been adopted which outlines the Organizational Structure being implemented and the associated Role of the Trustees (see discussion above). Further, the Compensation Committee has selected a compensation consultant to conduct the required survey. The members have also been briefed on the intermediate sanctions legislation and proposed regulations.

Pursuant to Stipulation No. 14, KSBE, as of August 6, 1999, adopted a plan to institute a single Chief Executive Officer ("CEO") structure to oversee the management of KSBE. The CEO will serve under and report directly to the Board of Trustees. It is envisioned that this new management structure will give the Trustees the responsibility of creating, sustaining and fulfilling KSBE's vision and mission, while making the CEO accountable for the development and execution of the plan to fulfill that mission and vision. Thus, any determination of reasonable compensation for Trustees will take this organizational structure and the duties delegated to the CEO into consideration.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

FINANCIAL REPORTING & INTERNAL CONTROLS

The Probate Court, as mandated by state law, will continue to oversee the affairs of KSBE. These oversight functions include appointing KSBE's Board of Trustees and reviewing and approving KSBE's Annual Accounts. In addition, several other controls are being adopted by KSBE including internal controls such as an internal audit function, employment and contract procedures, standard procurement practices, and internal control review.

Internal Audit Function

The Board of Trustees of KSBE and the KSBE Organizations are re-implementing an independent internal audit function to achieve, among other things, the following objectives:

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

As a large complex organization with significant land holdings and investments, KSBE is subject to certain significant business risks and challenges. As a charitable trust, it must comply with numerous state and federal laws, court orders and stipulations entered into since

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

inception. Because KSBE is also a tax-exempt organization, it must abide by certain strict rules and regulations to maintain its tax-exempt status.

For these as well as other important reasons, KSBE will re-implement an independent internal audit function to internally monitor its processes to ensure the organization's risks are adequately managed, that it is in compliance with legal and regulatory restrictions and that it is effectively utilizing the resources of KSBE to fulfill the terms of the Will of Bernice Pauahi Bishop. This function will be established in an organized manner with the proper purpose, structure, resources and commitment from the Board of Trustees.

The Board of Trustees has an established policy for the Internal Audit Function that outlines the mission of this function, its goals and objectives, as well as a general audit strategy. The mission of this function is as follows:

The mission of the Internal Audit Department is to assist the Trustees in the effective discharge of their fiduciary responsibilities through independent appraisal and examination of all control functions within KSBE, including functions of the Board of Trustees.

In order to establish a strong internal audit function and achieve the stated goals and objectives, the Board of Trustees has developed the following internal audit structure:

Audit Committee: KSBE will establish an audit committee that will be responsible for oversight of the audit process including both the internal and external audit functions. One of the primary responsibilities of the Audit Committee will be to set the "tone" for quality operational, financial and investment reporting, sound business risk

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

controls and ethical behavior throughout the organization. The Audit Committee will be comprised of two Trustees, the Court Master and a representative from the State of Hawaii Attorney General's office.

Director of Internal Audit: The Board of Trustees recognizes that a very important aspect of establishing an effective internal audit function is having a qualified Director of Internal Audit ("Director"). The Board of Trustees will appoint an individual with strong leadership, interpersonal, technical (business, finance and accounting), analytical, administrative and supervisory skills. Because the KSBE is a tax-exempt organization, KSBE will seek an individual for this position who also possesses tax knowledge and has experience in the area of tax-exempt organizations (see Appendix E of the Governance Policy attached as Exhibit H).

The Director will be empowered with full authority for directing the internal audit function of KSBE and report directly to the Audit Committee. The primary role of the Director will be to develop and direct a Comprehensive Audit Program within KSBE that accomplishes the mission as stated above. Administrative responsibility (i.e. performance evaluations, salary reviews, etc.) for the Director will rest with an appropriate level of upper management, which in the proposed organizational structure would be the Chief Executive Officer (CEO) of KSBE.

Internal Audit Function: In the execution of its responsibilities, the internal audit function will be independent of all other departments within the organization. The internal audit function will be a separate department reporting directly to the Audit Committee and, for audits that relate to or impact the taxable subsidiaries or affiliated

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

organizations, reporting will also be made to the Boards of Directors of the applicable taxable subsidiary or affiliated organizations.

The individuals in the internal audit function will have full and unrestricted access to all KSBE information and records, including those of the taxable subsidiaries, the affiliated organizations and the Board of Trustees. Accordingly, appropriate protections will be established to ensure the individuals in this function are immune from retribution from any member of the Board of Trustees, individually or in the aggregate, in the execution of their duties. Protections will also be made to ensure individuals within KSBE feel free to provide information to the internal audit function without detrimental or retaliatory actions as a result of their activities.

Due to the unlimited access to all KSBE information, all internal audit personnel will be held to the highest standard of integrity and confidentiality. They will serve as a role model for other departments.

Internal Audit Staffing: The Audit Committee and Director will determine the necessary staffing requirements for this function. The team will be comprised of qualified individuals with the varying core competencies necessary to effectively execute the audit work plan. The Board of Trustees has recognized that the way to build an effective internal audit group is not to limit the staff to those with traditional auditing backgrounds. The complexity of the organization will require the internal auditors to understand KSBE's strategy and the specific aspects of its critical program and operational processes. Therefore, KSBE will identify/hire individuals with experience in areas that are relevant to KSBE's educational purpose in addition to individuals with traditional audit experience.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

All audit results will be made in writing and addressed to the CEO, CFO, Audit Committee and the Principal Executive(s) responsible for the area audited. For the taxable subsidiaries and affiliated organizations, the report will also be addressed to the entity's Board of Directors (or designated committee), President and Chief Financial Officer. Copies will also be provided to other appropriate audit customers/process owners. Copies of all internal audit reports will also be kept on file by the Director and made available to the Court Master during the Annual Account review process.

Under the terms of the Closing Agreement, KSBE is to establish an independent internal audit function to monitor KSBE's compliance with the terms of the Closing Agreement, all Court orders and stipulations relevant to the Agreement and adherence to the Conflict of Interest Policy. The internal audit function will have responsibility to annually report the results of their monitoring of KSBE's compliance to the IRS as "Special Filings" during the term of the Closing Agreement. The Special Filings will be signed under the penalties of perjury and will also be filed by KSBE with the Court Master and the Attorney General of the State of Hawaii. The following summarizes the items to be included in the Special Filing.

- The internal auditor will evaluate and report whether business meetings between the Interim Trustees, Top Executives and the Incumbent Trustees are documented in writing detailing the purpose of the meeting and the persons who attended said meeting. For purposes of this reaffirmation submission, the term "Top Executive" is defined as an "Organization Manager" within the meaning of IRC Section 4958(f)(2).

- The internal auditor will report whether the Trustees are performing an annual performance review of the Chief Executive Officer.

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

- ❑ The internal auditor will evaluate whether a trustee or Top Executive has failed to comply with the Conflict of Interest policy during the term of the Closing Agreement. If a violation is identified, the internal auditor will report any apparent conflicts to the Board of Trustees for appropriate action. The internal auditor will include in the Special Filing the disposition of the apparent conflict to the Board of Trustees.

- ❑ The internal auditor will monitor KSBE's compliance with its established procurement practices and will review all contracts entered into over \$100,000 to ensure the practices were followed.

- ❑ The internal auditor will monitor KSBE's employment practices to ensure that appropriate standard employment procedures are followed and will review all new employment contracts over \$50,000.

- ❑ The internal auditor will evaluate KSBE's compliance with established procedures to ensure the proper and complete documentation and retention of all educational, investment and management decisions made by the Board of Trustees and by the Top Executives. The internal auditor will monitor whether the Board of Trustees' minutes contains documentation to indicate the Trustees present at the meeting and a record of the matters voted on, in addition to the acceptance or rejection of the particular matter. The internal auditor will also ensure any staff reports presented are attached and filed with the appropriate minutes and that in all instances where these documents concern the Trustees' fiduciary responsibilities as Trustees, these documents are readily available for inspection.

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

- The internal auditor will monitor KSBE's policy of not employing, or paying for the services of an elected or appointed member of the legislative, judicial or executive branches of government, whether state, federal or local, where such a relationship would create the appearance of a conflict of interest, until a period of three years has passed since the individual's status with the governmental entity has terminated.

Financial Statements

Pursuant to Stipulation No. 1 (Exhibit F), KSBE has adopted a specified format for financial statement reporting including the supplemental schedules (see example at Exhibit L). These financial statements will be audited and presented in conformity with orders of or stipulations approved by the Probate Court, and will, at a minimum, conform to general accepted accounting principles (GAAP).

KSBE will submit its financial statements to the Probate Court with the Annual Accounts. Additionally, for the effective period of the Closing Agreement, the financial statements, including all supplemental schedules, will be provided to the IRS.

Investment Schedules

In accordance with Stipulation No. 8, KSBE will annually prepare benchmarked investment performance schedules. The schedules shall be audited and attached to the annual financial statements submitted to the Probate Court with annual accounts of the Trustees (Exhibit L).

**Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480**

Under Stipulation No. 9 (Exhibit F), investment return analyses will be done utilizing agreed upon measures such as time weighed return and/or internal rate of return to allow for meaningful comparisons. These calculations will be compared to the benchmarks identified above for purposes of evaluating an investment's performance and its ongoing place in the portfolios of KSBE or the KSBE Organizations.

Employment and Contractual Relationships

KSBE is reviewing various relationships with providers of services or products in order to evaluate the cost-effectiveness and the efficiency of such relationships. The review of these relationships represents KSBE's effort to minimize waste and maximize the operations of KSBE in order to more effectively further its educational purposes.

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 KSBE and the KSBE Organizations and that the prices and/or compensation paid for such services are reasonable and commensurate with services rendered. Further, all significant job classifications in existence as of June 30, 1999 will be reviewed to ensure that the job positions and compensation for such positions are necessary and 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.

In a continuing effort to improve efficiency and effectiveness, KSBE will adopt standard procedures for all new contractual and employment relationships. These procedures will be followed for the contracting or hiring of any individual. Documentation will be maintained demonstrating the need for the services, why the proposed service provider/employee is the

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

most qualified candidate, that the price/salary is reasonable and the means to evaluate that the appropriate result/effort is gained from the service provider. In the case of all independent contractors, reports or other evidence that the contracted service was performed will be retained.

Finally, KSBE will establish a policy of not employing, reimbursing, or paying for the services of (including expenses of), an elected or appointed member of the legislative, judicial or executive branches of government, whether state, federal, or local, unless it receives the express permission of the Probate Court or such employee is specifically excluded from this policy under the terms of the Closing Agreement. This policy is applicable only when less than three years have passed since the individual's status with the governmental entity was terminated.

Procurement Practices

KSBE will adopt standard procurement practices to ensure that significant contracts will be awarded on the basis of open and competitive bidding, and that exceptions to competitive bidding will be specifically defined (see attached Exhibit M). These standard procurement practices include establishing approved vendor lists. Vendors would be added to the approved vendor list only if the vendors meet certain criteria established by management. Such criteria will include, but not be limited to, improving quality, gaining access to innovative technology, reducing total cost, and streamlining the purchasing process.

ORDER OF PRECEDENCE

Kamehameha Schools Bishop Estate
Supplemental Appendix to Form 1023
Reaffirmation Submission
FEIN: 99-0073480

This reaffirmation narrative is intended to only summarize the exhibits hereto. To the extent there are inconsistencies between this narrative summary and the exhibits, the exhibits control.