Nā Pua a Pauahi

AN ADDENDUM TO KAMEHAMEHA SCHOOLS ANNUAL REPORT

JULY 1, 2003 - JUNE 30, 2004

KAMEHAMEHA SCHOOLS & SUBSIDIARIES
Consolidated Financial Statements
& Supplemental Schedules

KPMG

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Consolidated Financial Statements and Supplemental Schedules

June 30, 2004 and 2003

(With Independent Auditors' Report Thereon)

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Consolidated Financial Statements and Supplemental Schedules

June 30, 2004 and 2003

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KPMG LLP
P.O. Box 4150
Honolulu, HI 96812-4150

Independent Auditors' Report

The Board of Trustees
Kamehameha Schools:

We have audited the accompanying consolidated balance sheets of Kamehameha Schools and subsidiaries as of June 30, 2004 and 2003, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of Kamehameha Schools' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kamehameha Schools and subsidiaries as of June 30, 2004 and 2003, and the changes in their net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits for the years ended June 30, 2004 and 2003, were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary information included in Schedules 1 and 2 for the years ended June 30, 2004 and 2003, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and in our opinion is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole for the years ended June 30, 2004 and 2003.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets of Kamehameha Schools and subsidiaries as of June 30, 2002, 2001, and 2000, and the related consolidated statements of activities and cash flows for the years then ended (none of which is presented herein), and we expressed unqualified opinions on those consolidated financial statements. The supplementary information included in Schedules 1 and 2 of Kamehameha Schools and subsidiaries' 2002, 2001, and 2000 consolidated financial statements was subjected to auditing procedures applied in the audits of those consolidated financial statements and, in our opinion, is fairly stated in all material respects, in relation to the consolidated financial statements from which it has been derived.

KPMG LLP

September 17, 2004

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2004 and 2003

(In thousands)

Assets		**2004**	**2003**
Cash and cash equivalents	$	53,162	168,068
Marketable debt and equity securities (notes 2 and 11)		3,704,056	3,406,019
Privately placed debt and equity securities (note 3)		665,582	306,790
Collateral received for loaned securities (note 2)		460,609	—
Assets held for sale from discontinued activities, net (note 4)		1,303	1,288
Receivables, net (note 5)		19,083	22,937
Property and equipment, net (note 6)		733,772	706,315
Real estate held for development and sale (note 7)		27,433	14,846
Deferred charges and other		43,985	38,637
Total assets	$	5,708,985	4,664,900
Liabilities and Net Assets			
Notes payable (note 8)	$	256,715	209,592
Obligation to repay securities lending collateral (note 2)		460,609	—
Accounts payable and accrued expenses		73,244	85,508
Income taxes payable (note 9)		24,702	28,141
Accrued pension liability (note 10)		46,232	42,641
Accrued postretirement benefits (note 10)		21,356	20,226
Deferred compensation payable (note 11)		9,480	8,952
Deferred income and other		21,553	17,274
Total liabilities		913,891	412,334
Net assets – unrestricted		4,795,094	4,252,566
Commitments and contingencies (notes 3, 4, 8, 9, 10, 11, and 15)			
Total liabilities and net assets	$	5,708,985	4,664,900

See accompanying notes to consolidated financial statements.

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Consolidated Statements of Activities

Years ended June 30, 2004 and 2003

(In thousands)

		2004	2003
Revenues, gains, and other support:			
Tuition and fees	$	13,551	9,918
Less financial aid		(5,738)	(5,413)
Net tuition and fees		7,813	4,505
Net realized and unrealized gains on investments (notes 2 and 3)		523,163	69,963
Rental (note 15)		127,939	140,467
Investment income (note 3)		94,024	77,840
Net gain on property sales (notes 7 and 12)		84,246	218,222
Other, including discontinued activities, net (notes 4, 9, and 13)		1,573	33,360
Total revenues, gains, and other support		838,758	544,357
Expenses:			
Educational programs		159,651	135,907
Management and general:			
Rental		55,608	57,566
Other (notes 8, 9, and 15)		80,971	46,849
Total expenses		296,230	240,322
Change in net assets		542,528	304,035
Net assets at beginning of year		4,252,566	3,948,531
Net assets at end of year	$	4,795,094	4,252,566

See accompanying notes to consolidated financial statements.

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 2004 and 2003

(In thousands)

		2004	2003
Cash flows from operating activities:			
Change in net assets	$	542,528	304,035
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:			
Net realized and unrealized gains on investments		(523,163)	(69,963)
Net gain on property sales		(84,246)	(218,222)
Gain on sale of discontinued activities		—	(59,876)
Depreciation and amortization		34,490	27,963
Losses (earnings) in investee companies		(12,469)	11,021
Changes in operating assets and liabilities:			
Decrease (increase) in assets held for sale from discontinued activities, net		(15)	33,427
Decrease in receivables, net		3,854	6,617
Increase in real estate held for development and sale		(6,162)	(4,272)
Increase in deferred charges and other		(5,348)	(7,522)
Increase (decrease) in accounts payable, accrued expenses, and other liabilities		(2,736)	2,678
Decrease in income taxes payable		(3,439)	(2,469)
Other		(535)	(512)
Net cash provided by (used in) operating activities		(57,241)	22,905
Cash flows from investing activities:			
Proceeds from property sales		112,367	292,855
Proceeds from sales of investments		8,964,898	9,431,895
Proceeds from sale of discontinued activities		—	127,639
Purchases of investments		(9,085,560)	(9,622,026)
Purchases of property and equipment		(96,493)	(154,765)
Net cash provided by (used in) investing activities		(104,788)	75,598
Cash flows from financing activities:			
Proceeds from borrowings		64,879	71,716
Repayment of borrowings		(17,756)	(23,400)
Net cash provided by financing activities		47,123	48,316
Net increase (decrease) in cash and cash equivalents		(114,906)	146,819
Cash and cash equivalents at beginning of year		168,068	21,249
Cash and cash equivalents at end of year	$	53,162	168,068
Supplemental disclosure of cash flow information:			
Income taxes paid	$	3,646	13,452
Interest paid		11,188	6,622
Supplemental disclosure of noncash investing activities:			
Transfer of property and equipment, net to real estate held for development and sale		17,413	—

See accompanying notes to consolidated financial statements.

(1) Summary of Significant Accounting Policies and Practices

(a) Description of the Organization

Kamehameha Schools (the Schools) is a charitable trust established under Hawaii law and operates under the terms of the Will of Bernice Pauahi Bishop, deceased. The Schools are governed by a Board of Trustees (the Trustees) and subject to jurisdiction of the First Circuit Court of the State of Hawaii (the Court). The primary assets of the Schools are lands and properties located in the state of Hawaii and debt and equity investments.

The Schools provide a variety of educational services for students of Hawaiian ancestry including early education (preschool), campus-based programs, and other extension and enrichment and summer school programs. Early education programs are conducted in various facilities throughout the state of Hawaii. The campus-based programs include campuses on the islands of Oahu, Maui, and Hawaii. The Oahu Campus is a kindergarten through grade 12 program. The Maui and Hawaii campuses are in their development stages and, as of June 30, 2004, served students from kindergarten through grade 10. These two campuses will expand over the next two years to include grades 11 and 12. The Schools are also engaged in summer programs, educational partnerships, and other programs that are outreach related and intended to provide educational opportunities to a greater population of students of Hawaiian Ancestry. In addition, the Schools provide a significant amount of scholarships for post-secondary education.

(b) Principles of Consolidation

The consolidated financial statements include the accounts of the Schools, Bishop Holdings Corporation (BHC), Ke Ali'i Pauahi Foundation (KAPF), and Newport Kohala, LLC.

The consolidated financial statements of BHC include the accounts of:

- Pauahi Management Corporation (PMC) and its wholly owned subsidiaries – KDP, Limited; KBH, Inc.; VCI, Inc.; Horton Grove Limited Liability Company; Lake Manassas Limited Liability Company; Treyburn Limited Liability Company; RTJ Limited Liability Company; and Paradise Petroleum, Inc. dba Ali'i Petroleum;
- In addition to those entities described above, PMC's consolidated financial statements included the discontinued activities of KUKUI, INC. and its wholly owned subsidiary, KUKUI Operating Company. KUKUI, INC. was engaged primarily in the acquisition, development, production, exploration for, and the sale of oil and natural gas. In May 2002, the board of directors of PMC approved a plan to dispose of the assets and liabilities of KUKUI, INC. On February 3, 2003, the stock of KUKUI, INC. was sold by PMC to a third party for approximately $128 million;
- P&C Insurance Company, Inc.; and
- Kamehameha Investment Corporation and its wholly owned subsidiaries – Keauhou Community Services, Inc.; Paki, Inc.; Keauhou Resort Development Corporation and its investment in Keauhou Kona Resort Company.

(Continued)

KAPF is a charitable organization whose exclusive purpose as a supporting organization is to actively engage in fundraising, scholarship, and development activities for the Schools.

BHC is a taxable holding corporation with subsidiaries primarily involved in property investment and management. The subsidiaries develop and sell real estate, maintain investments in equity and debt instruments, manage commercial properties on behalf of the Schools, and own and operate a hotel and a golf course. In 2004, the Schools approved a plan to outsource BHC's property management functions to third-party vendors for most of its commercial properties. As of July 1, 2004, BHC no longer manages any of the Schools' commercial properties.

P&C Insurance Company, Inc., a wholly owned subsidiary of BHC, is a captive insurance company that provides property and liability coverage for the Schools and its affiliates.

In addition to the above, under accounting principles generally accepted in the United States of America, certain investments may be considered as entities for consolidation should they meet specified criteria. As of June 30, 2004, Newport Kohala, LLC met these criteria. Newport Kohala, LLC is a single member limited liability company formed exclusively to execute the Schools' absolute return investment strategies and is managed by an independent investment management firm.

All significant intercompany transactions and accounts have been eliminated in consolidation.

(c) Basis of Financial Statement Presentation

The Schools' consolidated financial statements have been prepared on the accrual basis of accounting, and are presented in conformity with accounting principles generally accepted in the United States of America. Net assets, revenues, gains and other support, and expenses are classified based on the existence or absence of donor-imposed restrictions. All net assets of the Schools and changes therein are classified and reported as unrestricted net assets.

(d) Cash Equivalents

Cash equivalents are held in financial institutions located in the state of Hawaii and other states, and a liquid asset account offered by an investment bank. For purposes of the consolidated statements of cash flows, the Schools consider all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. The net cash balances maintained in excess of available depository insurance limits amounted to approximately $51.9 million and $166.6 million at June 30, 2004 and 2003, respectively.

(e) Investments

Marketable Debt and Equity Securities – The Schools

Debt and equity securities with readily determinable fair values are reported at fair value with unrealized gains and losses included in the consolidated statements of activities. Fair value is based on quoted market prices and, if applicable, discounted for restrictions on the sale of shares.

Marketable Debt and Equity Securities – BHC

Debt and equity securities are classified in one of three categories: trading, held-to-maturity, or available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity securities are those securities in which BHC has the ability and intent to hold the security until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized and realized gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are included in net assets - unrestricted in the accompanying consolidated balance sheets. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

At June 30, 2004 and 2003, debt and equity securities were classified as available-for-sale and were reported at amounts which approximate fair value.

A decline in the market value of any available-for-sale security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, BHC considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, and forecasted performance of the investee.

Privately Placed Debt and Equity Securities

Investments in which the Schools own 20% to 50% of the equity interest (5% to 50% for partnership investments) are accounted for primarily on the equity method. Certain limited partnership investments for which the Schools have in excess of 50% interest but do not have control are also accounted for on the equity method. Other investments in which the Schools have no significant influence are accounted for at cost.

A decline in the fair value of any held-to-maturity, privately placed debt or equity security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

(f) Receivables

Notes receivable consist primarily of receivables from the sale of residential leasehold lots to lessees under the single-family and multifamily residential land sales program, mortgage agreements from the sale of real estate to developers, and interest earned. The residential leasehold interests were sold under various collateralized financing arrangements with 5- to 15-year terms and monthly payments of both principal and interest or interest only. Annual interest rates range from 5% to 11% with a weighted average interest rate of approximately 7% at June 30, 2004 and 2003. The sale of leasehold lots under the financing arrangements is accounted for using the cost-recovery method whereby no profit is recognized until cash payments are received.

(g) Property and Equipment

Property and equipment are stated at cost. Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the assets. The estimated useful life of buildings and improvements is 30 years, land improvements is 30 years, and equipment is 5 to 10 years.

(h) Real Estate Held for Development and Sale

Real estate assets held for development and sale are stated at cost, net of any write-downs. Cost includes land acquisition and holding costs, site development, construction, and other project related costs. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, management uses estimated expected future net cash flows (undiscounted and excluding interest costs) to measure the recoverability of real estate assets held for development. The recoverability of real estate assets held for sale is determined by comparing appraised value or the net present value of the estimated expected future cash flows (using a discount rate commensurate with the risks involved) to the carrying amount of the asset. The estimate of expected future net cash flows is inherently uncertain and relies to a considerable extent on assumptions regarding current and future economic conditions. If, in future periods, there are changes in estimates or assumptions, the changes could result in an adjustment to the carrying amount of real estate.

Profit on sales of real estate is recognized when title has passed, minimum down payment criterion are met, the terms of any note received are such as to satisfy continuing investment requirements and collectibility of the note is reasonably assured, the risks and rewards of ownership have been transferred to the buyer, and there is no substantial continuing involvement with the property. If any of the aforementioned criteria is not met, profit is deferred and recognized under either the installment, cost recovery, deposit, or percentage-of-completion methods. Costs are charged to cost of sales on the basis of the relative sales value of the units sold to the total sales value of all units in the project.

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(i) Vacation

Professional teaching employees are employed under one-year contracts for school years ending in mid-August. School years comprise a "teaching period" from mid-August to mid-June and a "professional improvement period" for the balance of the year. Vacations for these employees are provided during the professional improvement period.

Substantially all the Schools' employees, except for professional teaching employees, earn vacation benefits and are entitled to receive payments for unused vacation benefits based upon their regular salary at the time of their termination of employment.

(j) Employee Benefits and Postretirement Plans

The Schools have a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation. The cost of this program is being funded currently.

The Schools also sponsor a defined benefit health care plan for substantially all retirees and employees. The Schools measure the costs of its obligation based on its best estimate. The net periodic costs are recognized as employees render the services necessary to earn the postretirement benefits.

In December 2003, SFAS No. 132 (revised), *Employers' Disclosure about Pensions and Other Postretirement Benefits,* was issued. SFAS No. 132 (revised) prescribes employers' disclosures about pension and other postretirement benefit plans, but does not change the measurement or recognition of those plans. In addition to the disclosure requirements contained in the original SFAS No. 132, the revised statement requires disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension and other postretirement benefit plans. The disclosures required under SFAS No. 132 (revised) are included in note 10.

The Schools and BHC have employee savings and profit sharing plans under Section 403(b) and Section 401(k) of the Internal Revenue Code. The plans cover substantially all the Schools' and BHC's employees after satisfying service requirements. Participating employees may defer up to 20% and 50% (subject to certain limitations) of their pretax earnings for Section 403(b) and Section 401(k) plans, respectively. Effective July 1, 2002, the Schools commenced employer contributions up to a maximum of 3% of pretax employee earnings.

(k) Deferred Income

Deferred income consists primarily of prepaid lease rents, which are deferred and recognized as income ratably over the fixed term of the respective leases.

(l) Income Taxes

In a ruling dated February 9, 1939, and as reaffirmed in 1969, 1986, and 2000, the Internal Revenue Service (IRS) determined that the Schools were exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code and organized and operated for educational purposes within the meaning of Section 170(b)(1)(A)(ii) of the Internal Revenue Code. KAPF is also exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code and qualifies as a supporting organization as described in Section 509(a)(3) of the Internal Revenue Code. To the extent that the Schools and KAPF receive unrelated business income, such earnings are subject to unrelated business income tax.

Income taxes for BHC are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. BHC utilizes the percentage method of allocating its consolidated tax liability among the entities of the BHC consolidated group.

(m) Use of Estimates

The preparation of the consolidated financial statements requires management of the Schools to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include the carrying amounts of property, equipment, and real estate held for development and sale; valuation allowances for receivables, investments, and deferred income tax assets; and assets and obligations related to employee benefits. Actual results could differ from those estimates.

(n) Impairment of Long-Lived Assets

The Schools adopted SFAS No. 144 on July 1, 2002. The adoption of SFAS No. 144 did not affect the Schools' consolidated financial statements.

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In accordance with SFAS No. 144, long-lived assets, such as property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the consolidated balance sheets and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheets.

(o) Commitments and Contingencies

Liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties, and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

(2) Marketable Debt and Equity Securities

Marketable debt and equity securities at June 30, 2004 and 2003 consisted of the following (in thousands):

	Fair value 2004	Fair value 2003
Common and preferred stocks	$ 1,578,551	1,356,522
Corporate debt securities	212,553	390,845
Government debt securities	220,774	261,938
Federal agency mortgage backed securities	215,429	295,280
Short-term investments	192,622	203,456
Mutual and commingled funds	1,284,127	897,978
	$ 3,704,056	3,406,019

Common and preferred stocks, corporate debt securities, and short-term investments are with corporations and mutual and commingled funds involved in various industries located throughout the United States and internationally.

Securities Lending

In September 2003, the Schools commenced participation in a securities lending program administered by its custodian bank. Under the program, certain equity and fixed income securities of the Schools were lent to participating financial institutions (borrowers) in exchange for collateral. Borrowers are required to deliver collateral equal to a minimum of 102% of the securities loaned. The collateral is marked to market daily. As of June 30, 2004, the Schools had limited credit exposure to borrowers because the fair value of collateral held by the Schools exceeded the fair value of securities loaned. As of June 30, 2004, the fair value of securities loaned amounted to $450.8 million and the associated collateral, comprised primarily of money market funds, amounted to $460.6 million.

(3) Privately Placed Debt and Equity Securities

The following schedule summarizes the carrying amount and fair value of the components of privately placed debt and equity securities at June 30, 2004 and 2003 (in thousands):

	2004		2003	
	Carrying amount	Fair value	Carrying amount	Fair value
Equity investments	$ 623,584	741,001	262,268	339,219
Direct financing lease	36,791	36,791	36,256	36,256
Loans and subordinated debentures	5,207	5,292	8,266	8,299
	$ 665,582	783,084	306,790	383,774

At June 30, 2004, the Schools' equity investments (cost method) had a carrying amount of $207.0 million, of which 13 investments reflected unrealized losses totaling $14.5 million (in thousands):

	Less than 12 continuous months			12 continuous months or longer			Total	
	Count	Fair value	Gross unrealized losses	Count	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses
Equity investments	3	$ 9,632	(585)	10	$ 41,972	(13,923)	51,604	(14,508)

Management has made an evaluation that carrying amounts will be recoverable and that none of the investments are permanently impaired. The gross unrealized losses are primarily due to the long-term nature of these investments and the investments are in the early years of their commitment periods. Further, the Schools have the ability and intent to hold the investments until the end of the commitment period.

The Schools' investment policy guides its asset allocation, which allows for the use of derivatives and other strategies which are achieved through limited partnerships and mutual funds. These investments pose no off-balance sheet risk to the Schools due to the limited liability structure of the investments.

(a) Equity Investments

Equity investments (accounted for on both the equity and cost methods) include interests in partnerships, corporations, real estate investment trusts, and other investment vehicles. These entities are involved in a diversified mix of real estate, retail, and financial activities in various geographical locations. The objectives of these entities include but are not limited to the following:

- Own apartments, retail shopping centers, and office buildings;
- Develop senior living communities;
- Acquire distressed real estate assets for either foreclosure or restructuring;
- Invest in:
  - Equity securities in various industries, including insurance, financial services, and healthcare;
  - Currently under-managed companies in need of sophisticated financial assistance;
  - Equity securities in connection with leveraged acquisitions;
  - Medium- and long-term investments in distressed fixed-income securities;
  - Equity, equity-related, and debt securities acquired through privately negotiated transactions; and
- Specialized portfolios of securities comprised of long and short positions in equity, equity-related, debt, and derivative securities.

Combined and condensed unaudited financial information (most recent available) for the investee companies that are accounted for on the equity method as of June 30, 2004 and 2003 is as follows (in thousands):

		2004	2003
Assets	$	2,277,089	1,300,121
Liabilities		526,085	416,194
Equity	$	1,751,004	883,927
Revenues	$	259,191	45,819
Expenses		123,738	172,725
Net income (loss)	$	135,453	(126,906)

(Continued)

The Schools' equity in earnings (losses) of investments amounted to $12.5 million and $(11.0) million for the years ended June 30, 2004 and 2003, respectively. These amounts are included in investment income in the accompanying consolidated statements of activities.

(b) Direct Financing Lease

BHC holds a 40-year lease for a golf course facility located in Virginia. The lease is accounted for as a direct financing lease. At June 30, 2004, the total minimum lease payments to be received and unearned finance charges were $76.7 million and $39.9 million, respectively. At June 30, 2003, the total minimum lease payments to be received and unearned finance charges were $77.8 million and $41.5 million, respectively. Future minimum annual lease payments amount to $1.1 million in 2005 and 2006, $1.6 million from 2007 to 2009, and $69.7 million in the aggregate thereafter. In addition to fixed minimum rentals, the lease agreement provides for percentage rent based on adjusted gross revenue of the golf course. There was no percentage rent for the years ended June 30, 2004 and 2003. The lessee has the option to purchase the golf club facilities either at the conclusion of the lease term or anytime during the lease term based on amounts specified in the lease agreement.

(c) Loans and Subordinated Debentures

Loans and subordinated debentures provide for principal and interest payments over various dates through 2008 with interest of 6.5% to 25.0% per annum.

(d) Net Realized and Unrealized Gains on Investments

Net realized and unrealized gains (losses) on investments for the years ended June 30, 2004 and 2003, by investment type, is as follows (in thousands):

		2004	2003
Marketable securities	$	470,335	88,407
Equity investments		52,828	(18,444)
	$	523,163	69,963

(e) Investment Income

Investment income (loss) for the years ended June 30, 2004 and 2003, by investment type, is as follows (in thousands):

		2004	2003
Marketable securities	$	70,890	80,017
Equity investments		15,055	(9,419)
Loans and subordinated debentures		4,958	4,760
Other		3,121	2,482
	$	94,024	77,840

(4) Assets Held for Sale from Discontinued Activities, Net

In September 1998, BHC sold substantially all of its interest in its coal bed methane wells as it relates to gas produced from the existing well bores. The terms of the sale were designed to allow the purchaser to be considered an owner of an economic interest in the gas produced for purposes of tax benefits that may be available under the Internal Revenue Code. BHC received a down payment of $1.7 million which reduced the basis in the properties, received tax credit payments from the purchaser based on the amount of natural gas produced, and received net profits interest carved out of the working interest equal to the cash flows from the production of the properties until certain events, as defined in the agreement, occurred. BHC received all cash flows from the existing wells until December 31, 2002, at which time BHC exercised its option to reacquire these properties for the current fair market value of $6.0 million. During the year ended June 30, 2003, BHC received tax credit payments of approximately $4.5 million and net profits interest of approximately $4.1 million. These amounts are included in other revenues, including discontinued activities, net, in the accompanying consolidated statements of activities.

In May 2002, BHC approved a plan to sell its oil and gas activities. On February 3, 2003, KUKUI, INC., which comprised a significant portion of BHC's oil and gas activities, was sold for $127.6 million, resulting in a gain of $59.9 million. Paradise Petroleum, a subsidiary of KUKUI, INC., was not included in the sale and became a wholly owned subsidiary of BHC. In August 2004, BHC sold certain assets of Paradise Petroleum and is continuing its efforts to sell the remaining assets. Accordingly, the results of the oil and gas activities, including the gain on sale of KUKUI, INC., net of related income taxes, are included as other revenues, including discontinued activities, net, in the accompanying consolidated statements of activities. For all periods presented, assets net of liabilities and cash flows related to the discontinued activities have been reported separately in the accompanying consolidated balance sheets and consolidated statements of cash flows. See note 13.

The assets and liabilities of the discontinued activities at June 30, 2004 and 2003 consisted of the following (in thousands):

		2004	2003
Cash and cash equivalents	$	674	617
Receivables and other, net		32	6
Property and equipment		600	666
Other assets		—	3
Total assets		1,306	1,292
Liabilities – accounts payable and accrued expenses		(3)	(4)
Assets held for sale from discontinued activities, net	$	1,303	1,288

(5) Receivables, Net

Receivables, net at June 30, 2004 and 2003 consisted of the following (in thousands):

		2004	2003
Note agreements	$	27,414	47,297
Less deferred profit on note agreements		(26,120)	(41,165)
		1,294	6,132
Tenant and tuition		12,901	12,784
Interest		10,407	8,657
Trade		4,207	6,807
Other		1,314	805
		30,123	35,185
Less allowance for doubtful accounts		(11,040)	(12,248)
	$	19,083	22,937

(6) Property and Equipment, Net

Property and equipment, net at June 30, 2004 and 2003 consisted of the following (in thousands):

		2004	2003
Educational property and equipment:			
Land	$	16,067	16,067
Buildings, improvements, and equipment		561,798	409,795
Less accumulated depreciation		(106,455)	(89,811)
		471,410	336,051
All other property and equipment:			
Land and land improvements		64,777	85,658
Buildings, improvements, and equipment		322,314	317,979
Less accumulated depreciation and amortization		(177,875)	(163,145)
		209,216	240,492
Construction in progress		53,146	129,772
	$	733,772	706,315

The provision for depreciation and amortization amounted to approximately $34.5 million and $28.0 million for the years ended June 30, 2004 and 2003, respectively.

For the year ended June 30, 2004, the book values of certain properties, buildings, and improvements were impaired. The properties were adjusted to fair value, which resulted in impairment losses of approximately $4.8 million. No impairment losses were recorded for the year ended June 30, 2003.

(7) Real Estate Held for Development and Sale

Real estate held for development and sale of $27.4 million and $14.8 million at June 30, 2004 and 2003, respectively, represents properties held by BHC. During 2002, the Schools approved plans to sell certain real estate assets. These assets, with a carrying amount of $60.5 million, were transferred from property and equipment to real estate held for development and sale in the accompanying consolidated balance sheets. In 2003, the Schools completed the sale of these assets and recorded a gain on sale of approximately $103.8 million for the year ended June 30, 2003, which is included in the accompanying consolidated statements of activities.

(8) Notes Payable

At June 30, 2004 and 2003, unsecured notes payable consisted of the following (columns in thousands):

		2004	2003
Senior promissory notes payable at the rate of 6.89% per annum with annual principal payments of $11.9 million beginning June 22, 2004, with final payment on June 22, 2013. The note agreement contains certain restrictions on assumption of additional debt and requires maintenance of a minimum endowment value and a certain liquidity ratio.	$	106,715	118,575
Senior promissory notes payable under a $150.0 million private shelf facility. The note agreement contains certain restrictions and requires maintenance of a minimum endowment value and a certain liquidity ratio:			
Interest rate of 6.80% per annum with annual principal payments of $952,000 beginning March 1, 2007, with final payment on March 1, 2027.		20,000	20,000
Interest rate of 4.88% per annum with annual principal payments of $3,333,000 beginning June 10, 2008, with final payment on June 10, 2028.		70,000	70,000
Interest rate of 4.93% per annum with annual principal payments of $4,000,000 beginning April 14, 2009, $3,000,000 beginning April 14, 2016, $2,000,000 beginning April 14, 2022 and $1,000,000 beginning April 14, 2028, with final payment due on April 14, 2029.		60,000	—
Note payable to a bank under a $6.0 million construction loan agreement which was terminated on March 31, 2004.		—	1,017
	$	256,715	209,592

In June 2004, the Schools entered into a $200.0 million uncommitted private shelf facility. Notes may be issued under this facility through June 2007 at interest rates determined at the time of issuance. There are no borrowings under this facility at June 30, 2004.

Annual maturities of notes payable are as follows (in thousands):

Year ending June 30:		
2005	$	11,860
2006		11,860
2007		12,812
2008		16,146
2009		20,146
Thereafter		183,891
	$	256,715

Interest expense, net of amounts capitalized of approximately $2.7 million and $3.4 million for the years ended June 30, 2004 and 2003, respectively, is as follows (in thousands):

		2004	2003
The Schools	$	11,088	6,418
BHC		712	132
	$	11,800	6,550

(9) Income Taxes

Total income tax expense amounted to approximately $10,000 and $9.7 million for the years ended June 30, 2004 and 2003, respectively. Of the total income tax expense of $9.7 million for the year ended June 30, 2003, an income tax benefit of $24 million was from continuing activities and an income tax expense of $33.7 million was from discontinued activities. The income tax expense (benefit) of approximately $10,000 and $(24) million for the years ended June 30, 2004 and 2003, respectively, is included in other management and general expenses in the accompanying consolidated statements of activities. The income tax expense of $33.7 million from discontinued activities for the year ended June 30, 2003 is included in other revenues, including discontinued activities, net, in the accompanying 2003 consolidated statements of activities.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of June 30, 2004 and 2003 are presented below (in thousands):

		2004	2003
Deferred tax assets:			
Difference in basis of investments and real estate	$	4,972	6,465
State tax provisions		1,963	1,972
Deferred income		1,604	1,303
Allowance for doubtful accounts		4,248	—
Other		2,351	5,977
Valuation allowance		(13,429)	(14,177)
		1,709	1,540
Deferred tax liabilities:			
Depreciation		(1,594)	(1,441)
Investment basis difference and other		(115)	(99)
		(1,709)	(1,540)
Net deferred taxes	$	—	—

The valuation allowance for deferred tax assets as of July 1, 2003 and 2002 was $14.2 million and $27.2 million, respectively. The total valuation allowance decreased by $0.8 million and $13.0 million for the years ended June 30, 2004 and 2003, respectively.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portions or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods which the deferred tax assets are deductible, management believes it is more likely than not that it will not realize the benefits of these deductible differences. The amount of the deferred tax assets considered realizable, however, could be increased in the near term if estimates of future taxable income during the carryforward period are increased.

IRS Audit

In 1995, the IRS began an audit of the Schools and Pauahi Holding Company (PHC), the Schools' former wholly owned taxable subsidiary, for the years ended June 30, 1992 to 1994. It was later expanded to include the years ended June 30, 1995 to 1998. In March 1999, the IRS began an audit of Kamehameha Activities Association (KAA) for the years ended June 30, 1997 and 1998. KAA, formerly a subsidiary of the Schools, merged with KAPF effective June 28, 2002, with KAPF as the surviving entity. This audit was later expanded to include the year ended June 30, 1999.

In January 1999, the IRS had proposed revocation of the Schools' tax-exempt status. Through settlement negotiation and the execution of a closing agreement in February 2000, which included removal of the five former Trustees, a settlement payment (including interest) of $14.0 million, and other conditions that require special filings to be made to the IRS annually through February 2005, the Schools were able to preserve their tax-exempt status.

PHC executed a closing agreement with the IRS in December 2000 to settle tax matters through June 30, 1998. The agreement resulted in a settlement payment (including interest) of $29.8 million that was paid during the year ended June 30, 2001.

In fiscal year 2002, the Schools and its related entities signed closing agreements with the IRS that resolved all outstanding tax issues relating to the taxable year ended July 31, 1998 for PHC, the taxable years ended through June 30, 1999 for KAA, and the taxable years ended through June 30, 2000 for the Schools. Under the agreements, KAA paid the IRS approximately $17 million (plus interest) and the for-profit subsidiaries paid $55.6 million in taxes (plus interest). The closing agreements also resulted in the transfer of the majority of KAA's assets to the Schools and the subsequent merger of KAA into KAPF, with KAPF as the surviving entity.

As a result of the IRS audit settlements, various states have initiated or are planning to initiate examinations of the Schools, KAA, and related entities. As of June 30, 2004, the states of California, Hawaii, and New York and New York City have initiated examinations, but no final assessments have been received, except by the State of Hawaii, which management intends to appeal. The New York State examination of a PHC subsidiary for the year ended July 31, 1998 resulted in a settlement payment of $1.6 million in taxes (plus interest) in fiscal year 2004. Management believes that it has adequately accrued for these taxes, and that the results of these examinations will not have a significant adverse effect on the Schools' consolidated financial position.

(10) Pension and Other Postretirement Benefits

The Schools have a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation. The Schools make annual contributions to the plan equal to the maximum amount that can be deducted for income tax purposes.

In addition to the Schools' defined benefit pension plan, the Schools sponsor a defined benefit health care plan that provides postretirement medical benefits to full-time employees who meet minimum age and service requirements. The Schools have the right to modify the terms of these benefits.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) became law in the United States. The Act introduces a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare benefit. In accordance with Financial Accounting Standards Board Staff Position FAS 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003,* the Schools will recognize the effects of the Act, if any, on the benefit obligation or cost in 2005. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require the Schools to change previously reported information. The measurement date used to determine pension and other postretirement benefit measures for the pension plan and the postretirement medical plan is June 30.

The funded status of the plans as of June 30, 2004 and 2003 is as follows (in thousands):

		Pension		Post retirement	
		2004	2003	2004	2003
Benefit obligations	$	179,759	186,974	24,337	21,545
Fair value of plan assets		122,292	105,293	—	—
Funded status	$	(57,467)	(81,681)	(24,337)	(21,545)
Accrued benefit cost recognized in the consolidated balance sheets	$	46,232	42,641	21,356	20,226

The accumulated benefit obligation for the pension plan was $143.6 million and $138.6 million at June 30, 2004 and 2003, respectively.

The amounts of net periodic benefit cost, contributions, and benefits paid for the years ended June 30, 2004 and 2003 are as follows (in thousands):

		Pension		Post retirement	
		2004	2003	2004	2003
Benefit cost	$	8,773	6,098	1,915	1,500
Employer contribution		5,182	—	785	601
Benefits paid		5,551	4,536	785	601
Plan participants' contributions		—	—	—	—

(Continued)

The assumptions used in the measurement of the Schools' benefit obligation and net periodic benefit cost for the years ended June 30, 2004 and 2003 are as follows:

	Pension		Post retirement	
	2004	**2003**	**2004**	**2003**
Benefit obligation				
Discount rate	6.25%	6.00%	6.25%	6.00%
Expected return on plan assets	8.00%	8.00%	N/A	N/A
Rate of compensation increase	4.80%	5.30%	N/A	N/A
Net periodic benefit cost				
Discount rate	6.00%	7.00%	6.00%	7.00%
Expected return on plan assets	8.00%	8.00%	N/A	N/A
Rate of compensation increase	4.80%	5.30%	N/A	N/A

The Schools overall expected long-term rate of return on plan assets is 8%. The expected long-term rate of return on plan assets was projected by the plan's investment consultants based on strategies outlined in the portfolios policies and guidelines.

For measurement purposes, a 10% and 15% annual rate of increase in the per capita cost of covered medical and drug benefits, respectively, was assumed for 2004. The rate was assumed to decrease gradually to 4.5% by the year 2012 and remain at that level thereafter.

(a) Plan Assets

The weighted-average asset allocation of the Schools' pension plan is as follows:

	Pension plan assets at June 30			
	2004	**2003**	**Target**	**Range**
Asset category:				
Equity securities	67%	64%	60%	47.5 – 72.5%
Debt securities	28%	31%	35%	17.5 – 45.0%
Real estate	5%	5%	5%	2.5 – 10%
Total	100%	100%	100%	

The Schools' investment goals for defined benefit pension plan assets are to maximize returns subject to specific risk management policies. Its risk management policies permit investments in debt and equity securities and real estate and other inflation-hedging assets. Readily marketable securities are utilized to pay benefit obligations as they become due.

(b) Cash Flows

The Schools expect to contribute $5.9 million to their pension plan and $0.8 million to their postretirement medical plan in 2005.

Benefits expected to be paid under the Schools' pension plan in each year from 2005 through 2009 are $6.1 million, $6.7 million, $7.3 million, $8.2 million, and $9.1 million, respectively. The aggregate benefits expected to be paid in the five years from 2010 to 2014 are $60.2 million. The expected benefits are based on the same assumptions used to measure the Schools' benefit obligation at June 30 and include estimated future employee service.

Benefits expected to be paid under the Schools' postretirement medical plan in each year from 2005 through 2009 are $0.8 million, $0.9 million, $1.0 million, $1.1 million, and $1.1 million, respectively. The aggregate benefits expected to be paid in the five years from 2010 to 2014 are $7.1 million. The expected benefits are based on the same assumptions used to measure the Schools benefit obligation at June 30 and include estimated future employee service.

The Schools also sponsor a 401(k) retirement savings plan covering substantially all eligible employees. The Schools make matching contributions to the 401(k) plan up to a maximum 3% of employee pretax earnings. Participants are immediately and fully vested in the Schools' contribution. Contributions to the 401(k) plan for the years ended June 30, 2004 and 2003 amounted to approximately $1.8 million and $1.6 million, respectively.

(11) Deferred Compensation Plan

On January 1, 1976, the Schools adopted a deferred compensation plan that allowed employees and others who perform services for the Schools under contract to defer compensation earned. Individual accounts are maintained for each participant and earnings are computed on the basis of alternative investment programs available. The liability has been fully funded and investments are included in marketable debt and equity securities in the consolidated balance sheets.

(12) Net Gain on Property Sales

Net gain on property sales for the years ended June 30, 2004 and 2003 consisted of the following (in thousands):

		2004	2003
Property sales	$	112,367	292,855
Less cost of property sales		(23,306)	(74,633)
Net property sales		89,061	218,222
Impairment loss on property and equipment (note 6)		(4,815)	—
	$	84,246	218,222

(13) Other Revenues, Including Discontinued Activities, Net

Other revenues, including discontinued activities, net, for the years ended June 30, 2004 and 2003 consisted of the following (in thousands):

		2004	2003
Continuing activities:			
Hotel operations	$	1,628	2,158
Less cost of hotel operations		(2,776)	(2,903)
Net hotel operations		(1,148)	(745)
Golf course operations		3,341	3,059
Less cost of golf course operations		(3,470)	(3,793)
Net golf course operations		(129)	(734)
Other		2,836	2,066
Other income, net from continuing activities		1,559	587
Discontinued activities (note 4):			
Oil and gas operations		68	21,218
Less cost of oil and gas operations		(54)	(14,663)
Net oil and gas operations		14	6,555
Gain on sale of discontinued activities		—	59,876
Income tax expense from discontinued activities (note 9)		—	(33,658)
Other income from discontinued activities		14	32,773
Other revenues, net	$	1,573	33,360

(14) Fair Value of Financial Instruments

The following table presents the carrying amounts and estimated fair values of the Schools' financial instruments at June 30, 2004 and 2003 (in thousands). The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

		2004		2003	
		Carrying amount	Fair value	Carrying amount	Fair value
Cash and cash equivalents	$	53,162	53,162	168,068	168,068
Marketable debt and equity securities		3,704,056	3,704,056	3,406,019	3,406,019
Privately placed debt and equity securities		665,582	783,084	306,790	383,774
Collateral received for loaned securities		460,609	460,609	—	—
Receivables, net		19,083	35,580	22,937	44,021
Notes payable		256,715	262,687	209,592	229,508
Obligation to repay securities lending collateral		460,609	460,609	—	—
Accounts payable and accrued expenses		73,244	73,244	85,508	85,508
Income taxes payable		24,702	24,702	28,141	28,141

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents, collateral received for loaned securities, obligation to repay securities lending collateral, accounts payable and accrued expenses, and income taxes payable: The carrying amounts approximate fair value because of the short maturity of these instruments.

Marketable debt and equity securities: The fair value of marketable debt and equity securities is based on quoted market prices, and if applicable, discounted for time restrictions.

Privately placed debt and equity securities: Different techniques and many factors were considered in deriving the fair value of these investments. Several investments have been valued based on the underlying asset value. Financial instruments with determinable cash flows were valued on the basis of their future principal and earnings distributions discounted at prevailing interest rates for similar investments. In addition, shares with quoted market prices with restrictions on the sale of shares were valued at market prices and discounted for time restrictions.

Receivables, net: The fair value of note agreements and mortgage notes is valued at the present value of expected future cash flows discounted at an interest rate commensurate with the risk associated with the respective receivables. The carrying value of interest and other receivables approximates fair value because of the short maturity of these instruments.

Notes payable: The fair value of notes payable is estimated using the current rates at which similar loans would be made by lenders to borrowers with similar credit ratings and similar remaining maturities.

(15) Commitments and Contingencies

(a) Rental Income

The majority of land and buildings are generally leased under long-term lease arrangements. At June 30, 2004, future rental income from these leases based on present effective minimum rentals is summarized as follows (in thousands):

Year ending June 30:		
2005	$	90,538
2006		87,276
2007		81,292
2008		73,806
2009		67,122
Thereafter		911,097
	$	1,311,131

Percentage rental income, based on stipulated percentages of gross lessees' sales, amounted to approximately $12.5 million for each of the years ended June 30, 2004 and 2003.

(b) Capital Commitments

At June 30, 2004 and 2003, the Schools were committed under agreements with certain partnerships and corporations to invest an additional $115 million and $60 million, respectively.

At June 30, 2004 and 2003, open construction, renovation, and major repair contracts amounted to approximately $37 million and $49 million, respectively.

(c) Litigation

The Schools, in the normal course of conducting their business, are a defendant or party in a number of civil actions. Management of the Schools is of the opinion that substantially all of these actions are either adequately covered by liability insurance or agreements with lessees or developers of the Schools' real estate and should not have a material adverse effect on the Schools' consolidated financial position.

(d) Trustee Matters

The Trustees receive an annual retainer of $30,000 payable monthly and will receive a meeting fee of $1,500 per meeting, except for the Chairperson, who will receive $2,000 per meeting. On January 23, 2004, the Court approved increasing the maximum number of meetings from 45 to 90 during a 12-month period. The Trustees elected to waive compensation for meetings in excess of 45 during the calendar year 2004. For the years ended June 30, 2004 and 2003, total Trustee compensation amounted to $540,500 and $479,500, respectively.

**KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES**

Schedules of Trust Spending

Years ended June 30, 2004, 2003, 2002, 2001, and 2000

(In thousands)

	2004	2003	2002	2001	2000
Trust spending, net:					
Campus-based programs:					
Kapalama	$ 73,852	71,663	70,661	72,081	66,955
Maui	18,187	12,845	5,266	3,721	3,193
Hawaii	20,264	12,697	5,300	2,407	1,826
Outreach-based programs:					
Extension education and summer programs	4,450	5,218	4,795	5,435	3,386
Early childhood education	18,016	17,516	17,060	14,552	12,787
Virtual campus	702	503	—	—	—
Financial aid/scholarships	17,001	16,412	16,726	16,852	16,634
Ke Ali'i Pauahi Foundation	730	1,984	3,322	—	—
Other program expenditures	10,433	7,457	2,681	4,828	6,283
Base spending (before Pauahi's Legacy Lives (Expansion))	163,635	146,295	125,811	119,876	111,064
Pauahi's Legacy Lives (Expansion) (net) (includes funding for Ho'okako'o, a not-for-profit organization, of $1,327 and $280 for the years ended June 30, 2004 and 2003, respectively.)	19,275	7,391	—	—	—
Base spending	182,910	153,686	125,811	119,876	111,064
Less: Tuition, fees, and other education income (net)	(7,776)	(4,518)	(4,128)	(3,109)	(3,047)
Less: Net income from agriculture and conservation lands	—	—	—	—	(154)
Base distributions	175,134	149,168	121,683	116,767	107,863
Major repairs	5,529	5,837	3,907	3,862	1,737
Capital projects	90,618	127,101	116,256	50,077	23,153
Interest on debt	4,776	1,360	—	—	—
Debt financing of capital projects	(60,000)	(70,000)	(20,000)	—	—
Total trust spending before reserve activity	216,057	213,466	221,846	170,706	132,753
Reserve activity – operating, net	4,500	6,000	1,000	35,400	—
Total trust spending	$ 220,557	219,466	222,846	206,106	132,753
Average market value of Endowment	$ 5,461,640	5,392,443	5,210,717	4,996,812	4,812,799
Trust spending rate before reserve activity	4.0%	4.0%	4.3%	3.4%	2.8%
Trust spending rate	4.0%	4.1%	4.3%	4.1%	2.8%

See accompanying independent auditors' report and notes to schedules of trust spending.

(1) Background and Purpose

The Schools' spending policy governs annual trust spending from the Endowment to support its educational purpose. The spending policy targets annual trust spending at 4% of the average market value of the Endowment plus the net income, if any, generated from the Schools' agriculture and conservation lands. The spending policy also provides for actual trust spending to vary annually in a range of 2.5% to 6%.

The schedule is prepared on a cash basis and presents the total distributions made from the Endowment to fund educational programs (trust spending) by major program and activity. It also presents the trust spending rates for the fiscal years ended June 30, 2004, 2003, 2002, 2001, and 2000.

(2) Trust Spending and Trust Spending Rate

Trust spending represents the amounts spent during the fiscal year on educational programs by major program and activity. The campus-based and outreach-based program costs represent direct and indirect costs of providing these programs. Ke Ali'i Pauahi Foundation expenditures represent the direct and indirect costs of providing scholarships and other education-related programs through January 2003 at which time these functions returned to the Schools. Other program expenditures represent the direct and indirect costs related to certain educational services that benefit the various campus-based and outreach-based programs. Indirect costs, which represents the portion of the finance, operations, and legal services cost that support the Schools' educational programs and purpose, are allocated to education based on various methods depending on the type of cost including headcount, square footage, and proportion in relation to the other estimates based on management's best judgment. Pauahi's Legacy Lives expenditures represent direct and indirect costs of the Schools' expansion programs. Major repairs, capital projects, interest on debt, and net borrowing of debt and repayment of principal, are directly attributable to education. Reserve activity represents the funding of an operating reserve, as approved by the Court, to ensure assets are readily available for unanticipated educational program expenses.

For purposes of this schedule, trust spending on educational programs includes major repairs and capital projects, an allocation of indirect costs, borrowing of debt, repayment of principal, and the funding of reserves. These items are not included in educational program expenses on the consolidated statements of activities. The trust spending rates are determined by dividing the total trust spending before reserve activity and the total trust spending by the average market value of the Endowment.

(3) Endowment and Average Market Value of the Endowment

The Endowment consists of all consolidated investment assets of the Schools except agriculture and conservation lands and reserve funds as defined in the Schools' investment policy.

The average market value of the Endowment is initially based on the average of the five prior fiscal June 30 year-end market values and over time will be based on the average of the prior 20-quarter-end market values. Accordingly, the trust spending rates for the years ended June 30, 2004, 2003, 2002, 2001, and 2000 are based on the estimated average market values over the last five fiscal years utilizing the respective year-end and/or quarter-end values. The market values for these fiscal years were based primarily on tax assessed values and internal and external appraisals, to the extent available, for the Hawaii real estate assets and the fair value of the other Endowment assets as reported in the audited consolidated financial statements for these fiscal years, net of any associated debt and certain applicable prior period adjustments.

Schedule 2

KAMEHAMEHA SCHOOLS
AND SUBSIDIARIES

Schedules of Total Return

As of and for the period ended June 30, 2004

Asset Class and Benchmarks	**Market value at June 30, 2004 (in thousands)**	**One year total return %**	**Three year total return %**	**Five year total return %**
Hawaii Real Estate:	$ 1,743,945	12.4	6.6	5.3
CPI+5%		8.3	7.2	7.8
U.S. Equity:	1,844,773	23.6	3.2	6.3
Russell 3000		20.5	0.1	(1.1)
Non-U.S. Equity:	870,209	30.7	6.6	5.6
MSCI EAFE / Emerging Markets Free Indices		30.9	4.4	0.1
Fixed Income:	838,062	2.1	7.6	7.3
Lehman Brothers Aggregate		0.3	6.4	6.9
Cash Equivalents:	86,691	1.1	2.0	3.4
Three-Month U.S. Treasury Bill		1.0	1.7	3.2
Alternative Investments:				
Venture & Private Equity:	157,279	34.3	(8.5)	(1.3)
CPI+10%		13.3	12.3	12.9
Absolute Return:	445,937	5.9	8.4	7.8
CPI+8%		11.3	10.3	10.8
Energy & Other:	25,181	19.1	19.9	35.5
CPI+5%		8.3	7.2	7.8
Real Estate (Mainland):	204,425	9.2	7.6	11.9
NCREIF Total Property Index		10.8	8.0	9.4
Total Portfolio	$ 6,216,502	15.4	6.6	7.8
Blended Portfolio		13.2	5.5	5.2
Cambridge Associates Large Endowment Fund Median		17.1	5.1	6.9
CPI+5%		8.3	7.2	7.8

See accompanying independent auditors’ report and notes to schedules of total return.

(1) Background and Purpose

The Schools' investment policy establishes long- and intermediate-term investment objectives, asset allocation targets, and performance measurement guidelines for the Endowment. The overall long-term investment objective of the Endowment is to earn an average annual net real return of 5% (Consumer Price Index plus 5%).

The purpose of this schedule is to report the Schools' total return results for the Endowment (by asset class) as compared to benchmark indices approved in the investment policy. The Schools' Endowment asset classes include:

(a) Hawaii Real Estate

The Hawaii real estate assets can be divided into traditional land holdings, improved commercial properties, real estate held for development and sale, and purchase money mortgages. The traditional land holdings are typically leased to third parties under long-term ground leases while the improved commercial properties are actively managed by various third-party managers to generate space rents. Improved commercial properties are comprised of shopping centers, office buildings, and warehouse facilities.

(b) U.S. Equity

U.S. equity is comprised of marketable equity securities of U.S. companies.

(c) Non-U.S. Equity

Non-U.S. equity is comprised of marketable equity securities of companies outside the U.S. These primarily include stocks of companies overseas in both developed and emerging markets.

(d) Fixed Income

Fixed income is comprised of investments in debt securities issued by a corporation, government, or government agency. This asset class also includes, to a lesser degree, money market instruments which include U.S. Treasury bills, bank certificates of deposit, repurchase agreements, commercial paper, and bankers' acceptances.

(e) Cash Equivalents

Cash equivalents is comprised of investments in debt securities issued by a corporation, government, or government agency and money market instruments.

(f) Venture and Private Equity

Venture and private equity investments can be defined as high risk, high potential return investments in nonmarketable securities such as equity or equity-linked investments in nonpublic companies, or in companies or parts of companies that are being taken private. These companies range from start-up enterprises to middle-market firms to public firms needing private financing for specific projects. The Schools' venture capital portfolio currently consists primarily of pooled fund investments in limited partnerships.

(g) Absolute Return

Absolute return investments have the general objective to produce relatively stable, positive returns regardless of the performance of the primary equity and fixed income markets. These may include the five broad strategies of event arbitrage, market neutral or hedged equity, distressed securities, hedge funds, and multi-strategy funds or fund of funds.

(h) Energy

Energy investments are used as an inflation hedge in the portfolio. This asset class is comprised of direct investments and limited interest partnerships.

(i) Real Estate (Mainland)

Mainland real estate assets consist of pooled and direct investments in residential, office, retail, timberland, and a variety of other property types.

(2) Market Values

Market value of an asset is the amount at which the asset could be exchanged in a current transaction between willing parties. The following methods and assumptions were used to estimate the market value of each asset class:

(a) Hawaii Real Estate

The market value of residential real property interests (single-family and multifamily) is estimated by internal appraisals using a discounted cash flow method for leased properties and sales comparison approach for unleased properties. The fee simple land values used as inputs within the discounted cash flow model for leased properties are based on estimates by external appraisers and are updated internally for current market conditions since the time that the appraisals were performed.

Commercial properties are divided into two primary categories – leased and unleased. As of June 30, 2004, commercial properties were externally appraised every three years. The market value of leased properties was typically estimated by the external appraisers using a discounted cash flow methodology, while the value of unleased properties was typically estimated using either a sales comparison or an income capitalization approach. Prior to June 30, 2004, for the properties that were internally appraised, the market value of leased properties was estimated by discounting future net cash flows at an appropriate discount rate over a ten-year period and the current tax-assessed values was used to approximate the market value of unleased commercial properties.

Either current tax-assessed value or external appraised values are used to approximate the market value of real estate held for future development and sale.

The market value of purchase money mortgages is estimated by discounting the expected future net cash flows at a discount rate commensurate with the risk associated with the respective receivables.

The market value of all real property interests is reduced by the market value of any associated debt.

(b) U.S. Equity

The market value of marketable equity securities is based on quoted market prices, and if applicable, discounted for time restrictions.

(c) Non-U.S. Equity

The market value of marketable equity securities is based on quoted market prices, and if applicable, discounted for time restrictions.

(d) Fixed Income

The market value of marketable debt securities is based on quoted market prices.

(e) Cash Equivalents

The market value of cash equivalents is based on quoted market prices.

(f) Venture and Private Equity

Different techniques and many factors were considered in deriving the market value of these investments. Several investments have been valued based on the underlying asset value. In addition, shares with quoted market prices with restrictions on the sale of shares were valued at market prices and discounted for the restrictions.

(g) Absolute Return

Different techniques and many factors were considered in deriving the market value of these investments. These investments have been valued based on the underlying asset value.

(h) Energy

Different techniques and many factors were considered in deriving the market value of these investments. Investments have been valued based on the underlying asset value. For certain assets, the market value was deemed to approximate the carrying value.

(i) Real Estate (Mainland)

Several pooled investments with determinable cash flows were valued on the basis of their future principal and earnings distributions discounted at prevailing interest rates for similar investments. Others were valued using the net operating income multiplied by a capitalization rate or independent appraisals.

Different techniques were considered in deriving the market value of direct investments. Fair value was based on independent appraisals, carrying value of a direct financing lease, and carrying value of operating assets reduced by liabilities.

The market value is reduced by the carrying value of any debt associated with such properties.

(Continued)

(3) Total Return

Total return is calculated using the Modified BAI Method, a time-weighted rate of return. Total returns for periods greater than one year are annualized.

(4) Benchmark Indices

The following represents the benchmark indices by asset class as approved in the investment policy:

Asset Class	Description
Hawaii Real Estate	Consumer Price Index plus 5%
U.S. equity	Russell 3000
Non-U.S. equity	MSCI EAFE/Emerging Markets Free Indices
Fixed income	Lehman Brothers Aggregate
Cash equivalents	Three-Month U.S. Treasury Bill
Alternative investments:	
Venture and private equity	Consumer Price Index plus 10%
Absolute return	Consumer Price Index plus 8%
Energy	Consumer Price Index plus 5%
Real Estate (Mainland)	National Council of Real Estate Investment Fiduciaries (NCREIF) Total Property Index
Total Endowment	Blended Portfolio Cambridge Associates Large Endowment Fund Median Consumer Price Index plus 5%

The MSCI EAFE/Emerging Markets Free Indices is a weighted benchmark based upon the asset class targets set forth in the Schools' approved investment policy. Effective January 1, 2004, the Blended Portfolio benchmark is also weighted based upon the asset class targets set forth in the Schools' approved investment policy. Prior to January 1, 2004, the benchmark was weighted by the percentage of Hawaii Real Estate fair market values and aggregate fair market values of all other asset classes combined.

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