Procedures & Findings Report

June 8, 2017

Table of Contents

Introduction

The University of Louisville ("UofL") issued a Request for Proposal ("RFP") dated September 26, 2016 for a "Special Forensic Audit" of UofL relating to the activities and accounts of the University of Louisville Foundation, Inc. ("ULF") and its subsidiaries and affiliates. Alvarez & Marsal Disputes and Investigations, LLC ("A&M") and nine other professional services firms responded to the RFP. UofL awarded the contract to A&M.

UofL and A&M entered into a personal services contract on November 29, 2016 to conduct a Special Forensic Investigation of the activities and accounts of ULF and its subsidiaries and affiliates from July 1, 2010 to June 30, 2016 (the "Engagement"). After gaining an understanding of the complexity of the ULF structure, the magnitude of the cash inflows and outflows, and the state of the books and records, A&M worked with UofL to refine the scope of the Engagement. UofL accepted A&M's recommendation to investigate ULF's financial transactions for the fiscal years ended June 30, 2014 through June 30, 2016[1] (the "Review Period") in detail and review select types of transactions over a longer time period.

This report ("Report") describes A&M's procedures and findings, ULF's policy and procedural changes responsive to A&M's findings, and A&M's recommendations in connection with the Engagement. A&M's procedures, findings, and recommendations are based on an investigation of the books and records of ULF and UofL. A&M relied upon certain representations and information provided by ULF and UofL. A&M did not perform an audit, examination, or review in accordance with generally accepted auditing standards or with other standards established by the American Institute of Certified Public Accountants ("AICPA"), the U.S. Securities and Exchange Commission ("SEC"), the Public Company Accounting Oversight Board ("PCAOB"), or other state, national, or international professional or regulatory bodies.

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[1] ULF's fiscal year ("FY") is July 1 through June 30.

Introduction

Limitations of Report

The Information has been prepared and compiled to assist UofL in evaluating issues related to ULF and the Special Forensic Investigation and does not purport to contain all necessary information that may be required to evaluate any entity or transaction, regardless of how pertinent or material such information may be. While the textual Information is believed to be accurate, in preparation of the Report, A&M has not independently verified any of the underlying source data which provided a basis for the Information. Accordingly, A&M makes no representation or warranty as to the accuracy, reliability or completeness of the Information and A&M is not responsible to any party, in any way, for any analysis contained in this report.

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Background

UofL created and designated ULF, an independent, 501(c)(3) not for profit corporation, to receive, invest, and distribute gifted and endowed funds donated to UofL. ULF's operations include the activities of 13 wholly owned subsidiaries and several joint venture partnerships. In fiscal year 2016, ULF transferred its ownership interests in certain subsidiaries and capital assets to ULREF, a separate real estate foundation created to hold and manage real property assets.

A 15-member board of directors oversees ULF. The ULF President and other ULF Officers manage ULF's day-to-day operations. All of the ULF Officers also held UofL titles. Historically, UofL employees typically performed the ULF financial and administrative tasks, with certain employees having responsibilities for both ULF and UofL.

ULF and ULREF (and their subsidiaries) recorded financial transactions in various accounting and financial reporting systems during the Review Period, with third-party firms recording financial transactions for certain subsidiaries. ULF incorporates the activities of the ULF Subsidiaries in its consolidated financial statements. Historically, ULF mainly used one bank account to fund its operations, commingling gift, endowment, and other cash receipts. Although the ULF Subsidiaries generally maintained separate bank accounts, ULF also funded subsidiary operations directly from its operating account.

Prior to A&M's Engagement, former ULF President, Dr. James Ramsey, resigned and ULF placed Kathleen Smith, Chief of Staff for the President and Assistant Secretary, on administrative leave. In December 2016, Keith Sherman became the ULF Interim Executive Director and Chief Operating Officer to manage ULF's and ULREF's operations. Mr. Sherman worked with the Foundation Financial Affairs Office to review and modify ULF's policies and procedures (a process the Foundation Financial Affairs Office started prior to Mr. Sherman's arrival). ULF has implemented a number of policy and procedural changes that address the issues discussed throughout this report, identified as "ULF Policy and Procedural Changes."

During the course of the Engagement, A&M performed a number of general procedures to obtain an understanding of ULF's organizational and operational structure. Based on its initial findings, A&M performed further review and analysis on select transactions or types of transactions, focusing on ULF's sources and uses of cash.

General Procedures and Findings

Preserved Data – A&M (in conjunction with UofL's IT Enterprise Security) imaged eight UofL and ULF servers and 115 hard drives and mobile devices, and preserved emails for 48 Custodians.

Reviewed Documents – A&M loaded documents and emails for select Custodians into a searchable database and reviewed thousands of emails using targeted keyword searches. A&M also searched and reviewed hundreds of documents from UofL and ULF servers.

Reviewed ULF Board of Directors Meeting Minutes – A&M obtained and reviewed all available meeting minutes, including those ULF did not maintain on its website.

Conducted Interviews – A&M conducted more than 100 interviews of current and former UofL/ULF employees and ULF Board of Director members, as well as third-party financial and legal services providers.[2]

Aggregated and Analyzed Data – A&M aggregated and analyzed a significant amount of transactional data, including a review of all cash transactions over $100 thousand during the Review Period.

A&M's general findings with respect to these procedures are as follows:

1. UofL's and ULF's substandard information technology policies and procedures resulted in lost data for certain Custodians.

2. The ULF Board of Directors lacked knowledge and oversight of certain significant transactions.

3. ULF Officers did not provide the ULF Board of Directors with sufficient information to allow them to make informed decisions.

4. ULF commingled its cash resulting in an inability to identify the source of funds for a specific disbursement.

[2] Dr. James Ramsey, former UofL President, declined an in-person interview with A&M. Additionally, eight of 18 former members of the ULF Board of Directors declined an interview with A&M.

Specific Findings

As A&M investigated ULF's cash transactions, it identified numerous issues related to ULF's use of cash, specifically ULF's depletion of Endowment assets. The following table summarizes the types of transactions where A&M identified significant issues.

Diagram 1

Transaction Types:
Unrecorded Endowment Losses
1(a) UHI Line of Credit
1(b) JGBCC Grant
Recorded Endowment Losses
2 Startup Company Investments
Excessive Spending
3(a) Spending Rate and Spending Policy Calculation
3(b) Endowment Gift Principal Spent
3(c) Liquidation of Additional Endowment Pool Assets
Unbudgeted or Over-Budget Spending
4(a) Compensation
4(b) Deferred Compensation
4(c) Real Estate
4(d) ULAA Transactions
4(e) Other Notable Spending
Underwater Endowments
5 Understated Underwater Endowments

Issues Identified:
ULF Depleted Endowment Assets
ULF Officers Exceeded Authority
ULF Failed to Properly Account for Transactions
ULF Presented Insufficient and/or Misleading Information
ULF Failed to Correct Known Issues
ULF Board of Directors Failed to Oversee ULF
Other Misellaneous Issues

1(a) Unrecorded Endowment Losses:
UHI Line of Credit

In April 2008 (and reaffirmed in November 2011), the ULF Board of Directors Executive Committee authorized ULF to loan $35 million of Endowment funds to UHI which in turn loaned the money to other ULF Subsidiaries. ULF recorded the intercompany loan (principal plus accrued interest) as an Endowment Pool asset. In fiscal year 2016, ULREF assumed $28.9 million of the UHI Line of Credit liability in conjunction with ULF's contribution of membership interests in certain ULF Subsidiaries to ULREF.

ULF ultimately loaned ULF Subsidiaries (through UHI) $52.2 million. The ULF Subsidiaries used the UHI Line of Credit proceeds to fund operating expenses (including interest payments for third-party loans), invest in joint ventures, and develop land (roads, lighting, etc.) for future building developments. Despite the fact that the ULF Subsidiaries currently (i) do not generate revenue, (ii) have debt in excess of real property values, and/or (iii) generate minimal cash flows (which to date ULF generally has not used to repay the UHI Line of Credit), ULF continues to record the market value of the UHI Line of Credit at $60.6 million (principal plus accrued interest) in the Endowment Pool.

Summary of Findings:

1. UHI loaned ULF Subsidiaries $52.2 million of Endowment funds the ULF Subsidiaries will likely not be able to repay.
2. The $52.2 million UHI loaned ULF Subsidiaries was $17.2 million more than the $35 million authorized by the ULF Board of Directors.
3. ULF did not record the UHI Line of Credit at fair value. Thus, ULF potentially overstated the Endowment Pool market value by $60.6 million.
4. ULF Officers did not provide the ULF Board of Directors sufficient information for the ULF Board of Directors to be fully informed about the UHI Line of Credit.
5. The ULF Board of Directors failed to properly oversee the UHI Line of Credit.

ULF Policy and Procedural Changes:
ULF plans to assess the collectability of the UHI Line of Credit, identifying the source of funds and timing in which it expects the ULF Subsidiaries (and now ULREF) could potentially repay the UHI Line of Credit. ULF informed A&M it would record valuation allowances for the UHI Line of Credit loan balances based on its assessment, appropriately reducing the reported UHI Line of Credit Endowment Pool asset value to reflect the fair value of the asset.

1(b) Unrecorded Endowment Losses: JGBCC Grant

ULF issued an intercompany loan to UHI, which UHI in turn granted to ULRF to fund $10 million of JGBCC research activities. ULF liquidated Endowment Pool assets to fund the JGBCC Grant, recording the principal plus accrued interest of the intercompany loan (between ULF and UHI) as an Endowment Pool asset. The JGBCC Grant included a repayment clause requiring ULRF to repay the funds if ULRF received a distribution from its 30% ownership in the Startup Company ACT.

ULRF's repayment of the grant was both contingent and remote, such that ULRF did not record a liability and UHI did not record a receivable (as advised by its auditors). However, ULF continued to report the $11.2 million intercompany loan balance (principal plus accrued interest) as an Endowment Pool asset. Further, despite the fact that ULF substantially wrote down its own direct investment in ACT based on the Startup Company's financial performance, ULF continued to record the intercompany loan at full value.

Summary of Findings:

1. ULF (through UHI) loaned ULRF $10 million of Endowment funds ULRF will not repay.
2. ULF transferred $10 million of Endowment funds for the JGBCC Grant without approval from the ULF Board of Directors.
3. The JGBCC Grant does not represent an asset. Thus, ULF overstated the Endowment Pool market value by $11.2 million.

ULF Policy and Procedural Changes:
Based on discussions with A&M, ULF agreed the JGBCC Grant does not represent an asset, and going forward ULF will not include the outstanding principal and interest in the Endowment Pool market value.

2 Recorded Endowment Losses: Startup Company Investments

In addition to the UHI Line of Credit, the ULF Board of Directors Executive Committee authorized ULF to invest $10 million of Endowment funds in "new ventures." Ultimately, ULF invested $9.9 million in high-risk Startup Companies which are currently valued around $1.7 million. In addition to ULF's investment, ULF and UofL entered into business relationships with the Startup Companies, including but not limited to, the Startup Companies renting office space from ULF Subsidiaries, contracting research from ULRF, and donating funds to UofL.

Summary of Findings:

1. ULF invested $9.9 million of Endowment Pool funds in high-risk Startup Companies currently valued at less than $2 million.
2. ULF effectively exceeded the $10 million ULF Board of Directors' authorized limit by guaranteeing loans and providing other benefits, likely costing ULF more than $3.2 million in additional losses.
3. It appears ULF did not report the market value of the Startup Company investments to the ULF Board of Directors until fiscal year 2015.
4. ULF Board of Directors, Entrepreneurial Group, and UofL Board of Trustee members' investments in the Startup Companies were not transparent.

5. Documents and interviewees indicate ULF required at least one Startup Company rent office space from a ULF Subsidiary in exchange for ULF's $3.2 million investment in the Startup Company.
6. It appears certain Startup Companies funded research through donations rather than Research Sponsorship Agreements to avoid paying UofL overhead charges.

3(a) Excessive Spending: Spending Rate and Spending Policy Calculation

ULF manages the Endowment funds allocated for spending with its Spending Policy, whereby ULF allocates 7.48% of the three-year historical average market value of the Endowment Pool (subject to certain adjustments and modifications) for spending each year. In certain years, Endowment Programs do not spend all of their Spending Policy Allocation, resulting in Spending Policy Allocation Carryover. The ULF Board of Directors approves the Spending Policy based on a recommendation from the Finance Committee.

Despite ULF's advisors' (and certain ULF Officers') concern that ULF's 7.48% spending rate was too high, ULF did not change its Spending Policy. The methodology ULF used to calculate its Spending Policy Allocation (which was at times in contradiction to direction from the ULF Board of Directors), resulted in an effective spend rate ranging from 8.21% to 9.26% during the Review Period.

Summary of Findings:

1. ULF's overstated Endowment Pool market value resulted in ULF spending in excess of 7.48% of the actual Endowment Pool market value.
2. Despite Cambridge's advice and the ULF Board of Directors Finance Committee directive, ULF failed to exclude the Spending Policy Allocation Carryover from its Spending Policy calculation.
3. ULF's Spending Policy disclosures were inaccurate and misleading.
4. ULF Officers and certain ULF Board of Directors members were aware the 7.48% Spending Policy would negatively impact the Endowment Pool and failed to make any substantive changes.

ULF Policy and Procedural Changes:

ULF modified its fiscal year 2018 Spending Policy, reducing its spending rate from 7.48% to 5.51% of the actual Endowment Pool market value, correcting the calculation methodology issues discussed in this report.

3(b) Excessive Spending: Endowment Gift Principal Spent

In December 2004, the ULF Board of Directors authorized the ULF President to spend $5 million over five years of an undesignated Quasi Endowment (earnings and interest) referred to as the Evergreen Fund to carry out "specific projects." The Evergreen Fund's market value just prior to the ULF Board of Directors' authorization was $17.6 million. In 2007, the ULF Board of Directors modified its authorization, removing the time restriction and seemingly the amount restriction.

ULF spent the entirety of the $17.6 million Evergreen Fund before March 31, 2014. Moreover, a number of expenditures funded such as executive compensation and bowl game trips do not appear to be in accordance with the "special projects" for which the ULF Board of Directors authorized the funds.

Summary of Findings:

1. ULF expended the Evergreen Fund (more than $17.6 million in Endowment Gift Principal and earnings) by March 2014.
2. Certain Evergreen Fund expenditures do not appear to be in accordance with the ULF Board of Directors' authorization.
3. It does not appear the ULF Board of Directors monitored ULF's Evergreen Fund expenditures.

3(c) Excessive Spending: Liquidation of Additional Endowment Pool Assets

The ULF Board of Directors approved the majority of ULF's expenditures each year through the ULF Budget, which mainly consisted of expenditures related to the Spending Policy Allocation. Occasionally, the ULF Board of Directors would approve expenditures outside of the ULF Budget, such as real estate acquisitions.

The ULF Budget did not represent a complete operating budget, with significant, known expenditures excluded, such as ULF compensation and Cambridge advisory fees. Moreover, a number of expenditures exceeded budget, including spending managed by the Office of the President. Further, ULF also purchased a significant amount of unbudgeted real property. The ULF Board of Directors at times approved the real property acquisitions without any identification of the source of funds used. ULF's unbudgeted and over-budget expenditures contributed to ULF liquidating $42 million of

Endowment Pool assets in excess of the Spending Policy Allocation during the Review Period. ULF's effective spending rate was as high as 15.14% during the Review Period (accounting for the additional Endowment Pool assets liquidated for spending and the historically overstated Endowment Pool market value).

Summary of Findings:

1. ULF liquidated $42 million of Endowment Pool assets to fund unbudgeted and over-budget spending.
2. ULF did not include significant expenditures in the ULF Budget provided to the ULF Board of Directors.
3. ULF Officers identified the liquidation of Endowment Pool assets in excess of the Spending Policy Allocation as an issue but failed to make any substantive changes.
4. ULF Officers failed to inform the ULF Board of Directors of the Endowment Pool assets liquidated for spending in excess of the Spending Policy Allocation.
5. The ULF Board of Directors did not monitor ULF spending to ensure it was in accordance with the ULF Budget.

ULF Policy and Procedural Changes:

ULF made several cash management changes to limit excessive spending, including separating Endowment, Current Use Gift, and operating funds as well as not funding UofL Spending Policy Allocation overages. For fiscal year 2018, ULF prepared a complete operating budget inclusive of all known or estimable expenditures.

4(a) Unbudgeted or Over-Budget Spending: Compensation

Historically, UofL administered UofL and ULF payroll, issuing one paycheck for employees who performed tasks for both UofL and ULF. Additionally, certain UofL/ULF employees were compensated by UHI in addition to their UofL/ULF salaries.

ULF did not include ULF compensation and/or ULF Subsidiary compensation in the ULF Budget in all periods, contributing to ULF's liquidation of Endowment Pool assets in excess of the Spending Policy Allocation. Additionally, from calendar years 2010 through 2016, UHI paid $1.7 million to employees (generally funded by the UHI Line of Credit), the majority of whom also received UofL/ULF salaries. ULF Officers attempted to conceal compensation paid by UHI from open records requests.

Summary of Findings:

1. ULF used Endowment Pool funds (the UHI Line of Credit) to pay select ULF and UofL employees $1.7 million in additional compensation paid through UHI.
2. ULF paid compensation in excess of budgeted amounts approved by the ULF Board of Directors.
3. The additional compensation paid through UHI was not transparent.

ULF Policy and Procedural Changes:
ULF no longer separately compensates employees from UHI and included all known compensation expenditures in the fiscal year 2018 ULF Budget. ULF instituted new policies to ensure its open records requests are complete and accurate.

4(b) Unbudgeted or Over-Budget Spending: Deferred Compensation

Certain ULF, UofL, and ULAA employees received deferred compensation agreements funded by ULF whereby the employees received compensation in addition to their salaries in the form of contributions, accrued earnings, and tax gross-ups.

ULF did not include deferred compensation in the ULF Budget (at the direction of the Office of the President), contributing to ULF's liquidation of Endowment Pool assets in excess of the Spending Policy Allocation, as well as the diversion of funds intended for other commitments ULF is now unable to satisfy. From 2005 through 2016 the deferred compensation Plan cost ULF $21.8 million, consisting of $8.4 million of vested contributions, $4.1 million of accrued earnings, and $9.2 million of tax gross-ups. It does not appear the ULF Board of Directors monitored, reviewed, or in some instances even approved these expenditures. Moreover, ULF Officers worked to conceal the deferred compensation from open records requests.

Summary of Findings:

1. ULF administered a deferred compensation Plan costing ULF more than $21.8 million, including contributions and earnings of $12.5 million paid to nine employees.
2. It appears ULF paid deferred compensation not approved by the ULF Board of Directors.
3. ULF's deferred compensation was not transparent.

4. The ULF Board of Directors failed to oversee the deferred compensation Plan.
5. ULF failed to maintain appropriate deferred compensation Plan records.

ULF Policy and Procedural Changes:
The ULF Board of Directors terminated the deferred compensation Plan on March 31, 2017. ULF instituted new policies to ensure its open records requests are complete and accurate.

4(c) Unbudgeted or Over-Budget Spending: Real Estate

ULF holds a number of real property assets it acquired through various means and for different purposes, some of which do not generate revenue and/or are not currently used. ULF's real estate acquisition process lacked formal policies and procedures, including in certain instances no formal purchase approval or identification of funding. As a result, ULF purchased properties at prices above the appraised values (interviewees identifying them as "strategic" or "defensive" purchases).

Summary of Findings:

1. ULF acquired eight properties at an aggregate $10.3 million above appraised value.
2. ULF paid $30.1 million for non-revenue generating properties.
3. ULF entered into below market tenant and ground leases for developed properties.
4. It appears ULF Officers failed to provide the ULF Board of Directors sufficient information related to the real property acquisitions.

ULF Policy and Procedural Changes:
ULF and ULREF are in the process of assessing each property and determining the highest and best use for each property. ULF and ULREF are also considering possible disposition of some properties.

4(d) Unbudgeted or Over-Budget Spending: ULAA Transactions

ULAA and ULF engaged in various transactions whereby ULF purchased properties or funded other expenditures on behalf of ULAA and in return ULAA (i) waived required donations for football and men's basketball tickets and (ii) transferred cash to UofL. In addition to these expenditures, ULF funded the Office of the President's purchase of $800 thousand for season tickets each fiscal year. Like ULF's other unbudgeted expenditures, these property and ticket purchases contributed to ULF's liquidation of Endowment Pool assets in excess of the Spending Policy Allocation. Further, ULF also liquidated Endowment assets to fund an intercompany loan to CCG to purchase a golf course. Finally, ULF Officers worked to conceal the details of its arrangements with ULAA.

Summary of Findings:

1. ULF expended monies on behalf of ULAA and in return ULAA transferred cash to UofL and waived required donations on season tickets purchased by the Office of the President.
2. ULF spent $15.1 million on ULAA's behalf for which it only received $11.6 million in consideration.
3. ULF funded $4.9 million in compensation paid to certain ULAA employees.
4. In addition to $9.6 million of Ticket Donations ULF satisfied by expending funds on behalf of ULAA, ULF paid ULAA more than $800 thousand annually for football and men's basketball season tickets.
5. ULF liquidated Endowment funds to purchase ULGC.
6. The ULF and ULAA transactions were not transparent.
7. It does not appear the ULF Board of Directors was informed of and/or authorized all of the ULAA property acquisitions.

ULF Policy and Procedural Changes:

ULF is in the process of assessing each property and determining the highest and best use of the ULAA Properties, including potential lease payments to be paid by ULAA in the future. The Office of the President eliminated a significant portion of its annual ticket purchases.

<u>4(e) Unbudgeted or Over-Budget Spending:</u>
<u>Other Notable Spending</u>

ULF expended funds on a number of items that appeared to be excessive, not in accordance with UofL's policies, and/or unbudgeted or over-budget contributing to

ULF's liquidation of Endowment Pool assets in excess of the Spending Policy Allocation.

Summary of Findings:

1. ULF funded $5.2 million of marketing and advertising expenditures which contributed to ULF exceeding the ULF Budget.
2. ULF funded $4.5 million of legal and landscaping expenditures which contributed to ULF exceeding the ULF Budget.
3. ULF paid $243 thousand in consulting fees to certain Entrepreneurial Group members.
4. Certain Office of the President procurement card purchases may not be in accordance with UofL's policies.

ULF Policy and Procedural Changes:
ULF is in the process of reviewing and identifying unnecessary expenditures, including future spending commitments made by the former administration, and negotiating price reductions or extended payment terms where possible. UofL is also in the process of implementing changes to its procurement card policies and procedures, creating a centralized procurement card review team who will review procurement card reports in addition to the departmental review.

5 Underwater Endowments:
Understated Underwater Endowments

As a result of ULF's excessive spending, ULF's Underwater Endowments (Permanently Restricted Endowment Programs for which the current market value is less than the Endowment Gift Principal) have increased substantially. ULF reported $0.6 million, $4.5 million, and $23.7 million of Underwater Endowments as of June 30, 2014, 2015, and 2016, respectively. Had ULF not overstated the market value of certain ULF Managed Endowment Pool assets, ULF would have potentially reported Underwater Endowments up to $10.4 million, $29.2 million, and $58.0 million as of June 30, 2014, 2015, and 2016, respectively.

Summary of Findings:

1. ULF's spending resulted in reported Underwater Endowments of $23.7 million as of June 30, 2016.

2. ULF's overstated Endowment Pool market value resulted in ULF understating its Underwater Endowments by up to $34.4 million

ULF Policy and Procedural Changes:
In fiscal year 2016, ULF implemented changes to start removing Current Use Gifts from the Endowment Pool and separately investing them in marketable securities. Additionally, ULF is assessing the collectability of the UHI Line of Credit, identifying the source of funds and timing in which it expects ULF Subsidiaries (and now ULREF) could potentially repay the loans and will record valuation allowances based on its assessment. Additionally, ULF modified its Spending Policy to reduce its spending and expects that will mitigate (and potentially limit) the impact of these market value changes will have on Underwater Endowments.