ATTACHMENT
CONFIDENTIAL

UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 81 OF THE AUDIT COMMITTEE

May 17, 2006

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, May 17, 2006 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy (Vice-Chair)
Ms Dominique Barker
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. David Oxtoby
Mr. Roger P. Parkinson
Professor Gordon Richardson
Mr. Mark Weisdorf
Mr. Robert S. Weiss

Ms Catherine J. Riggall, Vice-President, Business Affairs
Mr. Mark L. Britt, Director, Internal Audit Department
Ms Sheila Brown, Chief Financial Officer
Mr. Louis R. Charpentier, Secretary of the Governing Council

Secretariat:

Mr. Neil Dobbs
Mr. Andrew O. P. Drummond

Regrets:

Mr. Richard Nunn
Mr. Christopher Sparks

In Attendance:

Mr. Eric Fleming, Director, Risk Management and Insurance
Mr. Pierre Piché, Controller and Director of Financial Services
Ms Martha Tory, Ernst & Young

1. Report of the Previous Meeting

Report Number 80 (March 22, 2006) was amended to include Mr. Robert S. Weiss in the list of members who sent regrets for the meeting.

THE FOLLOWING TWO ITEMS ARE RECOMMENDED TO THE BUSINESS BOARD FOR APPROVAL.

2. Internal Audit Policy: Revision

Mr. Charpentier recalled that the Committee had at its previous meeting considered a proposed, revised Internal Audit Policy. The changes proposed at that time had been incorporated in the revised draft.

At the request of the Committee Secretary, page 2 of the memorandum covering the proposed policy was corrected to read as follows, to reflect accurately an amendment agreed at the previous meeting:

> In the listings of the specific areas of the Internal Audit mandate beginning on page 1, the following caveat was removed: 'to the extent resources are available.' That caveat was retained for the list on page 2 of the consulting services to be provided upon request to University administrators.

On the recommendation of the Secretary of the Governing Council,

YOUR COMMITTEE RECOMMENDS

THAT the proposed revised Internal Audit Policy, a copy of which is attached hereto as Appendix "A", be approved, replacing the Policy approved on November 23, 1992.

3. Audit Committee Terms of Reference: Revision

Mr. Charpentier recalled that the Committee had also considered the proposed, revised Audit Committee Terms of Reference at its previous meeting. Again, the changes proposed at that time had been incorporated in the revised draft. Mr. Charpentier referred to a concern that had been raised in the past few days concerning the proposal that the voting members of the Committee "are normally members of the Governing Council or Business Board." The concern was that the requirement might have a steering effect on the appointment of external members of the Governing Council and Business Board; by requiring so many members with specifically financial expertise, there might be insufficient places for external members of the Governing Council and Business Board with expertise in such other essential areas as human resources. Mr. Charpentier said that the objective was that members of the Audit Committee have, through their membership of the Governing Council or Business Board, a good working knowledge of the business management of the University that would be difficult for members to acquire through attendance only at the four annual meetings of the Audit Committee. It was not intended that all members of the Audit Committee have a high level of financial expertise. Although most or all would have financial knowledge, some members might not be financial experts.

3. Audit Committee Terms of Reference: Revision (Cont'd)

Among the matters that arose in discussion were the following.

(a) Report on legal actions. A member noted that while the Committee would, in connection with its review of the audited financial statements, continue to review a list of pending legal actions, it would no longer review a report on the overall use of legal services. He asked the reason for the proposed change. Ms Brown replied that the objective of the review of substantial pending legal actions was to enable the Committee to satisfy itself with respect to the note in the financial statements concerning contingent liabilities. It also assisted the Committee in carrying out its responsibility to monitor risk exposures. The previous report on the use of legal services and fees was not relevant to the Committee's responsibilities. The cost of such services represented a very small element of the University's overall operating budget, and it was the responsibility of the administration to monitor and control that element of expense in the same manner it controlled other expenses.

A member commented that he found that the annual report on the use of legal services was useful to assist the Committee in identifying areas of risk exposure and trends in potential exposure. While there might be questions asked about particular use of legal services, it was not the intention to second-guess the administration in its management decisions.

Ms Brown noted that the Governing Council had recently approved the establishment of the position of Senior Legal Counsel and an appointment to that position, and the University had generally expanded its in-house legal staff. The Chair said that the fact that a great deal of legal work was now performed in-house changed the landscape and meant that the report on the use of external legal services would be much less useful in helping to monitor risk exposure. The Committee would be able to rely on the external auditors to survey both external and internal legal counsel and to draw to the Committee's attention all major legal actions and risks.

(b) Whistle-blower policy. A member referred to part 5.1.4(d) of the proposed terms of reference that called upon the Committee to review periodically "the policies and processes for individual members of the University to draw to the attention of appropriate University officers, including the Director of the Internal Audit Department, any significant financial issues, problems or irregularities." A member suggested that in addition to oversight of the whistle-blower policy, the Committee should receive some level of reporting. It was also appropriate that, especially for allegations of financial misdeeds by senior officers, members of the University be able to report their concerns to the Chair of the Audit Committee. Such a provision would reflect best practice, and it would be a particularly important step for an institution that prided itself in its open system of governance. The Chair and Mr. Britt replied that it would be entirely appropriate for the whistle-blower policy itself to require the Director of Internal Audit to make regular reports to the Audit Committee with respect to matters that arose under whistle-blower arrangement and to require prompt, special reports of all matters raised with respect to the actions of senior officers. Indeed, it was within the mandate of the Director of Internal Audit to make precisely such reports. In response to a question, Mr. Britt described the actions he would take in response to allegations of financial impropriety, including allegations

3. Audit Committee Terms of Reference: Revision (Cont'd)

concerning senior officers. He said that he would look into the allegation and report it to the Chief Financial Officer and to the Secretary of the Governing Council. If there was a *prima facie* reason to do so, he would begin a formal special review. If there was significant risk, the President or the appropriate Vice-President would be advised and would receive a copy of the report of the special review. Like all special reviews, Mr. Britt would make a report to the Audit Committee and include the matter in his annual report. In the case of an allegation of financial misbehaviour by a very senior officer, Mr. Britt would discuss the matter immediately with the Secretary of the Governing Council and would report to matter to the Chair of the Audit Committee.

In the course of discussion, it was AGREED that the Committee's assessors examine the whistle-blower policy and bring the policy, revised if appropriate, to the Committee for its review. It was suggested that the policy provide for the receipt and logging of all calls by an independent person and for a review of the log by the Audit Committee. It was also suggested that the annual accountability reports include a statement that the person had reported any instances of fraud or other financial misbehaviour seen during the year in accordance with the whistle-blower provisions.

In the course of discussion, it was noted that there were other provisions within the University for the report of other-than-financial misbehaviour. They included the University Ombudsperson, the report of allegations of misbehaviour by the University Police to the Metropolitan Toronto Police, and the report of health and safety violations to the appropriate Ministry.

On the recommendation of the Secretary of the Governing Council,

YOUR COMMITTEE RECOMMENDS

(a) THAT the proposed revised terms of reference of the Audit Committee, a copy of which is attached hereto as Appendix "B", be approved; and

(b) THAT the Business Board rescind its instruction, made on October 15, 1996, that the Audit Committee carry out the Board's stewardship responsibility with respect to the incorporated business ancillary operations, and that the Board itself receive for information the annual reports and audited financial statements of those operations.

THE FOLLOWING ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

4. Audited Financial Statements for the Year Ended April 30, 2006: Draft Notes

Mr. Piché said that each year the Committee reviewed the notes to the audited financial statements before the statements as a whole were presented at the June meeting. He outlined the major changes.

- **Note 2(a), Significant accounting policies and reporting practices: investments**. The note had been updated to include the means used to value private-markets investments including real estate and private-equity investments.

- **Note 2(b), Significant accounting policies and reporting practices: derivative financial instruments**. The paragraph on using derivative financial instruments for hedging was reworded for greater clarity.

- **Note 3, Employee benefit plans**. The note had been updated to include the 2006-07 actuarial assumptions used to measure the University's accrued benefit obligation and benefit cost. There had also been, arising from the Committee's discussion one year previously, a change in the order of the items showing the reconciliation of (i) the accrued liability on the balance sheet for pensions and other employee future benefits, and (ii) the plan deficits reported in note 3. (The difference arose from the amortization over several years of changes in the annual actuarial valuations and the change in accounting from valuing assets at a smoothed market value to fair market value.)

- **Note 4, Investments** had been revised to report real-asset and private-equity investments separately.

- **Note 4, Investments: Derivative financial instruments – foreign currency forward and equity index futures contracts**. The fair value of foreign-currency forwards and equity-index-futures contracts had previously been reported on a net basis. The revised note reported the value of the contracts in accounts receivable and in accounts payable and accrued liabilities.

- **Note 10, Series C senior unsecured debenture**. The new note disclosed the details of the $75-million debenture issued in November 2005.

- **Note 15, Ontario Student Opportunity Trust Fund**. Pursuant to Government requirements, the note displayed the status of endowments supported by the first and second phases of the Ontario Student Opportunity Trust Fund (O.S.O.T.F.) program, which matched donations to endowments to support student aid. That program had now ended.

- **Note 16, Ontario Trust for Student Support**. The O.S.O.T.F. had been replaced by the Ontario Trust for Student Support. Pursuant to Government requirements, the financial information concerning the endowments supported by the program were reported for the Government's fiscal year, which ended on March 31.

4. Audited Financial Statements for the Year Ended April 30, 2006: Draft Notes (Cont'd)

Members asked a number of detailed questions. Among the suggestions that arose in discussion were the following.

(a) Note 4, Derivative financial instruments: description. A member suggested the rewording of the note describing the University's interest-rate swap contracts to stress that they were intended to manage cash-flow exposure.

(b) Note 1(g), Summary of significant accounting policies and reporting practices: revenue recognition – deferral method of accounting for donations and government grants. In response to discussion, Mr. Piché undertook to give further consideration to the wording of the description of the recording of contributions that were restricted for certain purposes in an effort to clarify the highly complex accounting requirements.

(c) Note 3, Employee benefit plans. In response to members' questions, Mr. Piché said that the discount rate used to calculate the accrued benefit obligation for pension and other post-retirement benefit plans had been reduced from 5.75% to 5.25%, to match current long-term bond rates. Depending on the valuation of the assets, he estimated that the outcome of the lower discount rate would be a $32-million increase in the pension and other benefit liabilities and a $20-million increase in the pension and benefit expenses reported in the financial statements. A member urged that the major effect of the changed assumption be made clear in the note. Ms Brown replied that the effect would be made clear in the financial highlights section of the Financial Report and that the administration would consider whether also to expand the notes to display the impact of the changed assumption. Wherever reported, it would be clear from the Financial Report that the increase in the liabilities and the expenses was not the outcome of salary or benefit increases.

5. Risk Assessment Profile, 2006

The Chair recalled that the Audit Committee terms of reference called upon the Committee to review

> an annual management report on significant business, financial and regulatory risks and [to] monitor the University's processes for identifying and controlling those risks. In carrying out this responsibility, the Committee focuses primarily on the adequacy of key controls over those vital risks considered to be, currently or in the future, more significant and likely to occur, meets with management and the internal or external auditors to come to a fuller understanding and better assessment of management's response to controlling important risk situations.

The Committee "reports any concerns to the University's senior officer reporting to the President responsible for financial matters, to the President, or to the Business Board, as appropriate."

Ms Brown presented the key points in the risk-assessment profile for 2006.

6. Risk Management and Insurance: Annual Report, 2005-06

Mr. Fleming said that the report retained the same format as previous years, which had been well received. The financial results of the insurance program had deteriorated over the past year because of the 24% increase in the premiums for the property and general liability policies provided by the Canadian Universities Reciprocal Insurance Exchange (CURIE). The cost of other policies purchased commercially had remained steady or even declined slightly. CURIE, because of its overall poor claims experience, had been required by its actuaries to raise its premiums substantially over the past three years in order to rebuild its surplus. With its increased revenue and with a moderating claims experience, CURIE had been able to build its surplus to $11.2-million as at December 31, 2005, up from $6.0-million the previous year. The commercial insurance market was currently very healthy, with the average return on equity enjoyed by property and casualty insurers having been 17%. The University's claims experience had been excellent, with almost no claims on the CURIE and external policies. The University's self-insurance reserve, however, had encountered a difficult year. That reserve, which was used to handle the $250,000 deductible on the University's property insurance, had been required to meet the nearly $250,000 cost of flooding damage at the University of Toronto at Scarborough caused by a torrential rainfall in August 2005. Apart from that claim, the experience of the self-insurance reserve had been relatively normal, and occasional large claims were to be expected.

Mr. Fleming noted that the University's commitment to CURIE ended at the end of December, 2007. Because of the premium increases over the previous three years and the addition of certain restrictions on coverage, the University had some concerns with respect to CURIE. It had therefore begun its planning for a review of insurance services. The administration would report further on the matter to the Committee and it would request members' advice. Ms Brown added that the University would be looking at a variety of options. It had advised CURIE of the University's review and of the reasons for concern about CURIE. The University wished to give CURIE every opportunity to make the appropriate changes.

Discussion focused on the following topics.

(a) CURIE. In response to questions, Ms Brown and Mr. Fleming said that the University would not, should it withdraw from CURIE, receive any share of CURIE's surplus, which would be retained to deal with future claims. CURIE had, in its earlier years, made distributions from its surplus – prematurely as it subsequently became clear. It appeared likely that the University would have received somewhat better rates from a commercial insurer in recent years, but it was not possible to quantify the amount. The reason was that commercial insurers did not provide comparable coverage because CURIE's policies were designed specifically for universities. The coverage was growing slightly out of date, but CURIE was working on bringing the policies more up to date. Ms Riggall said that it would not be appropriate to say that the University of Toronto was subsidizing CURIE. CURIE did not disclose its claims experience or the premiums it charged various users to members of the Reciprocal. That was one of the reasons the University of Toronto was concerned about CURIE. This University was seeking increased disclosure.

In response to a question, Ms Riggall said that the decision on staying with CURIE or moving to the commercial market would be based primarily on economic considerations, but the University

6. Risk Management and Insurance: Annual Report, 2005-06 (Cont'd)

would take other factors into account. It did wish CURIE to understand clearly that this University's continuing participation could not be assumed if CURIE did not address the University's concerns. In response to further questions, Ms Brown said that the establishment of CURIE had been of very great benefit to the University. At the time of CURIE's establishment in the late 1980s, the University had been unable to obtain commercial coverage. That CURIE provided coverage that was customized to the needs of universities (including coverage for participation in athletic activities, off-campus practica, etc.) was very important. The CURIE Board appeared to be making efforts to be responsive to the University's concerns. Those concerns involved CURIE governance, transparency with respect to claims experience and opportunities to purchase coverage with higher deductibles and lower prices. If the University's concerns were met, if CURIE's financial position was solid, and if the prices for policies were good, the University would very much like to retain its participation in the Reciprocal.

Mr. Fleming noted that some of CURIE's problems were beyond its control. CURIE was a risk-sharing entity of universities across Canada. Each of those universities had different risks and different exposures to catastrophe. When, for example, a hurricane hit universities in the Maritime provinces, all members had to share the cost of the claims through their increased premiums.

A member noted that CURIE had lost its $2.5-million stop-loss reinsurance protection because of its claims frequency, and it was now exposed up to $5-million for each and every claim – therefore exposing its members to further rate increases and special assessments. Should the University act to guard itself against the risk of an additional assessment? Mr. Fleming explained that the claim problem had arisen from the damage caused to the Maritimes universities by Hurricane Juan in 2003. He agreed that the outcome was further exposure to this University and other participants.

The Chair asked whether the University could consider moving in cooperation with other public-sector institutions to group purchases of insurance coverage with appropriately designed coverage and advantageous rates. Ms Riggall and Ms Brown replied that the facilities operations of the Toronto universities and colleges and the Toronto District School Board were purchasing supplies in that manner, and the Government of Ontario was promoting a co-operative buying initiative. Such an option could also presumably be considered for insurance purchases.

(b) Self-insurance reserve. A member observed that the $2,500 deductible payable by individual budget units making insurance claims had not been changed for many years. Especially given the stress on the self-insurance reserve, would it be appropriate to increase the deductible at this time? Ms Brown replied that she had reviewed the question with the Vice-Provost, Planning and Budget, and they had reached the conclusion that it would be best to leave the deductible unchanged. The deductible was intended to ensure that budget units took responsibility for their facilities and equipment. There was no reason to believe that the divisions were not now assuming that responsibility and making their best efforts. The fact was that the University was an open environment and there would inevitably be losses. Any increase in the premium would simply have the effect of exporting budget reductions from the reserve to the

6. Risk Management and Insurance: Annual Report, 2005-06 (Cont'd)

divisions. Under the new budget model, it would clearly be best to leave the deductible unchanged.

In the course of discussion, members complemented Mr. Fleming on the report. Two members expressed pleasure with the University's own good claims experience.

7. Capital Projects: Financial Report, May 1, 2006

Ms Brown recalled that the capital projects financial report was a regular monitoring report, requested by the Chair. It was similar to the capital projects report presented at each meeting of the Business Board, but it added variances between the approved cost of each project and the actual or projected cost There were no significant variances in the current report.

8. Report of the Administration

Ms Riggall, Ms Brown, Mr. Piché, Mr. Charpentier and Mr. Britt stated that they knew of no other items that should be brought to the attention of the Committee at this time.

9. Date of Next Meeting

The Chair reminded members that the final regular meeting of the academic year was scheduled for Wednesday, June 21 at 5:00 p.m. The major item of business would be the review of the audited financial statements.

The meeting adjourned at 5:30 p.m.

Secretary	Chair

August 21, 2006
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