UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 90 OF THE AUDIT COMMITTEE

May 19, 2009

To the Business Board,
University of Toronto.

Your Committee reports that it met on Tuesday, May 19, 2009 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

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

Mr. Neil Dobbs, Secretary

Regrets:

Professor Ramy Elitzur
Mr. Joseph Mapa

In Attendance:

Mr. Pierre G. Piché, Controller and Director of Financial Services
Ms Martha J. Tory, Ernst & Young

ALL ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

1. Report of the Previous Meeting

Report Number 89 (December 3, 2008) was approved.

2. Business Arising from the Report of the Previous Meeting

(a) Item 3 – Pension Plans: Revised Annual Financial Report for the Year ended June 30, 2008

Ms Riggall reported that the University had updated its annual financial report on the pension plans, as presented to the Committee in December. The report had been updated to include a change in the solvency valuation, using the increased discount rate specified by the Canadian Institute of Actuaries. The revised valuation as at June 30, 2008, had been filed with the Financial Services Commission of Ontario. As a result of the filing, the University would not be required to make another filing of the actuarial valuation until 2011, providing an additional year for a possible turnaround in the financial markets and an improvement in the value of the plan assets.

2. Business Arising from the Report of the Previous Meeting (Cont'd)

(a) Item 3 – Pension Plans: Revised Annual Financial Report for the Year ended June 30, 2008 (Cont'd)

Ms Brown noted that the revised Annual Financial Report on the Pension Plan had been submitted to the Business Board at its meeting of March 23, 2009. She recalled that the actuarial valuation of the main registered plan had included: (a) a going-concern valuation, showing a deficit of $165.4-million, (b) a solvency valuation, showing a deficit of $217.2-million as well as (c) a hypothetical wind-up valuation. The new discount rate established by the Canadian Institute of Actuaries affected only the solvency valuation. The discount rate had previously been 4.5%, the appropriate Government of Canada bond yield plus 40 basis points. The Institute, noting increasing interest rates on other-than-Government credit, had then increased the spread by 70 basis points (70/100 of 1%), and it had concluded that the new rate would be appropriate for use in 2008 valuations, effective February 29, 2008 and thereafter. The University had therefore arranged a revised solvency valuation using the higher discount rate, which had reduced the solvency deficit from $217.2-million to $65.5-million. As a result of the filing, the University had been required to make an immediate additional contribution of $14.8-million to the main pension plan. That amount was, however, within the $27.2-million budgeted each year for special pension plan contributions, over and above the usual current service contributions. A proportion of that $27.2-million had been directed to the main registered pension plan. The next pension plan valuation that would be required for submission to the Financial Services Commission of Ontario, in the absence of any plan changes, had previously been one effective July 1, 2010. It would now be July 1, 2011. The revised Annual Financial Report on the Pension Plan was available for consultation on the Financial Services website.*

(b) Item 7 - Endowment: Annual Financial Report for the Year Ended April 30, 2008

The Chair recalled that at the time of the discussion of this report, there had been uncertainty about the possibility of an endowment payout for the current year. Given that the markets had provided a return of about 33% since their February low, he asked about the outlook for a payout. Ms Brown recalled that the endowment investments in the Consolidated Investment Pool had lost 29.5% for the 2008 calendar year. The Pool was invested in a very diversified portfolio, including a substantial proportion in private equity and hedge funds. Because of the time lag in the valuation of such funds, Ms Brown did not anticipate that the Pool would have made a recovery that was in line with the public equity markets.

Ms Riggall said that it had been decided to make no payout at the end of the 2008-09 fiscal year in order to preserve the greatest possible proportion of the value of the capital of the endowment funds. The University did anticipate that it would make some payout for the 2009-10 year. Divisions had been drawing down their reserve funds to meet commitments to pay faculty members who held endowed chairs and to provide the need-based student aid that would normally be funded from endowments.

---

* http://www.finance.utoronto.ca/Assets/reports/pension/2008.pdf

2. Business Arising from the Report of the Previous Meeting (Cont'd)

(b) Item 7 - Endowment: Annual Financial Report for Year Ended April 30, 2008 (Cont'd)

A member asked whether there was a University policy requiring Divisions to set aside reserve funds. Ms Brown replied that ancillary operations were required to set aside reserves. There was no policy requiring the Divisions funded through the operating budget to do so. However, pursuant to the new budget model, in which divisions' spending budgets derived from the revenue they generated, they were encouraged to set aside reserves to deal with any contingencies that might arise. In addition to formally reserved funds, Divisions had access to other funds. Each endowment account had an expendable account associated with it which was used to receive and disburse the proceeds of the endowment. Many of those expendable accounts had funds left in them, which had been only partially used up to support the purposes of the endowment. In addition, Divisions often had trust funds containing expendable amounts derived from such sources as grants and donations. While each had strict limits on its use, in some cases those limits were broad, and the trust funds could be used for purposes determined by the beneficiary departments.

(c) Item 6 – Internal Audit Department Semi-Annual Report

Ms Riggall recalled that in the discussion of the Semi-Annual Report of the Internal Audit Department, a question had arisen concerning the University's backup of electronic data. Ms Riggall had reported on the backup procedures for the St. George Campus, and she had undertaken to update that report with respect to backup on the Mississauga and Scarborough campuses. She reported that on both campuses, data was backed up daily to a disc drive and weekly to tape for storage off site.

3. Audited Financial Statements for the Year Ended April 30, 2009: Draft Notes

The Chair noted that the full financial statements would come before the Committee again at the June 17, 2009 meeting, at which time the Committee would consider a motion for their approval. The current review of the notes provided an opportunity for members to comment on proposed changes before they were included in the final draft of the statements.

Mr. Piché summarized the changes to the notes.

- **Note 2(a) – Change in accounting policies**. First, the University, like other issuers of financial statements, was now required to provide a statement of objectives, policies and processes for managing capital, which the University would do by the addition of a new note 3, "Capital Management." Second, not-for-profit organizations were no longer required to provide a separate disclosure on the balance sheet of the amount of net assets invested in capital assets. The University would include that amount for 2008-09, and retroactively for comparative purposes, in its internally restricted net assets. The net assets invested in capital assets would be shown in note 14, which outlined the components of internally restricted assets.

3. Audited Financial Statements for the Year Ended April 30, 2009: Draft Notes (Cont'd)

- **Note 2(m) – Financial instruments**. The University would for the 2008-09 statements continue to apply the Canadian Institute of Chartered Accountants (C.I.C.A.) Handbook rule 3861 concerning Financial Instruments – Disclosure and Presentation. For 2009-10, however, the University did plan to apply two alternative rules, C.I.C.A. 3862 – Financial Instruments – Disclosures, and C.I.C.A. 3863 – Financial Instruments – Presentation. The latter rules provided for more disclosure concerning the risk involved in the University's financial instruments – in effect a sensitivity analysis of such risk. That disclosure would be required for the 2010 financial statements for the pension plans. It would therefore make sense to provide similar disclosure in the University's statements.

- **Note 2(n) – Future accounting policy changes**. First, for future financial statements the C.I.C.A. would require not-for-profit organizations to include cash-flow statements. Second, certain revenues and associated expenses, currently reported on a net basis, would have to be reported separately on a gross basis in the statement of operations. Third, the C.I.C.A had clarified its definition of what could and could not be recognized in the financial statements as an asset. For example, advertising costs would no longer be allowed within the definition of an asset and could not be capitalized. This redefinition was not expected to have an impact on the University's financial statements.

- **Note 3 – Capital management**. The new note on capital management described the University's focus on liquid resources available for operations. The note stated the University's objectives were (a) to have sufficient liquid resources to continue operations even in the event of adverse financial events, and (b) to take advantage of opportunities that would advance its mission. The note also described the University's ability to raise funds to finance its capital (building) program.

  A member asked how the University was able to manage liquid resources on a daily basis in an environment where responsibility for spending was broadly distributed to the Divisions and their officers. Mr. Piché replied that three-month forecasts were prepared and updated daily as required, and cash that was not expected to be needed for operations was either invested in a short-term investment account or transferred to UTAM for investment in the Expendable Funds Investment Pool (EFIP). Forecasting was possible because the Financial Services Office had good information on Divisions' spending plans and could aggregate those plans to predict overall cash-flow needs. Divisions' plans tended to be reasonably stable and predictable. Where Divisions planned major items of spending that were out of the ordinary, their financial officers usually provided advance information to the Financial Services Office. A member observed that the process was one comparable to that of a multi-national corporation, which had to have a global view of its overall operations.

  A member expressed surprise that a section of the notes dealing with capital management would focus on liquid resources and day-to-day cash management. The member would have expected the section to discuss such matters as measures to protect the health of

3. Audited Financial Statements for the Year Ended April 30, 2009: Draft Notes (Cont'd)

long-term funds such as the endowed funds, providing information on the policies to protect the value of the capital of those funds from investment risk and from deterioration as the result of inflation. Ms Tory noted that there was considerable latitude permitted in the definition of capital by individual companies or organizations. Each selected an approach that was most useful to the organization. The important thing was to define capital appropriately in order to avoid confusion of liquid capital and longer-term capital. Mr. Piché said that the University's policies with respect to its long-term capital, such as its endowment funds, were readily available, and it did not therefore appear to be beneficial to repeat those policies in section 3 of the notes. The member observed that there were currently substantial challenges to the value of the long-term capital, which would make reference to those policies particularly valuable at this time. Ms Tory said that the definition of capital selected by the University did appear to her to be appropriate. The endowment funds were put into place and were managed consistently according to a long-term framework. Shorter-term capital was the focus of management attention. In addition, the University did prepare an annual report specifically on the endowment, and an abbreviated statement in the notes would not add to that report and might, on the contrary, focus attention on too brief a statement about the endowment. In response to the member's question, Ms Tory affirmed that she was satisfied that the University's definition was appropriate in its particular circumstances. Ms Tory added that it would be valuable to clarify the definition of capital as being liquid resources. That was especially important because of the University's use of an investment pool for its expendable funds – something that was not generally in place in other organizations. Ms Brown stressed that the monies in EFIP were not fully expendable at the University's discretion. The objective of the Pool was to combine various funds for investment purposes. The EFIP included unspent operating cash, but it also included divisional reserve funds, grant funds received but not yet spent for research projects, etc.

A member referred to the statement in the note concerning the financing of capital assets and the University's borrowing policy, which defined its external borrowing capacity as "40% of net assets smoothed over five years." He suggested the use of the word "averaged" rather than "smoothed," which could have a negative connotation.

- **Note 4 – Employee benefit plans**. The University would use a new discount rate in calculating its accrued benefit obligations for its employee benefit plans, in particular the pension plan obligations. That discount rate was based on the effective yield for AA rated corporate bonds, and the University would use a rate of 7.75%, which was an increase from the 6.00% used the previous year. The outcome would be a reduction in the accrued benefit obligation of $600-million. It was important to bear in mind that at the same time the value of the pension-plan assets had declined substantially. In response to a member's question, Mr. Piché said that the increase in pension expense for 2009-10 would be about $70-million. A member noted that the discount rate on the liabilities would be higher than the expected long-term rate of return on the plan assets.

3. Audited Financial Statements for the Year Ended April 30, 2009: Draft Notes (Cont'd)

- **Note 5 – Investment of endowed funds**. In response to a member's question, Mr. Piché said that a new paragraph disclosed the University's investment loss for 2009 on its internally restricted endowments and its income on investments other than those held for endowments. In previous years, that information had been included in another paragraph, but it would be presented in a separate paragraph this year in the light of the losses incurred during the year.

- **Note 5 – Investments: Uncalled commitments**. While the disclosure was not required, Mr. Piché had thought it appropriate to make clear in the notes the significant amount that had been committed to investment in private funds managed by third-party managers. Investors in such funds were required to make an initial commitment and then to remit the amounts called by the managers over a stated period of time. Such uncalled commitments had amounted to $249-million as at April 30, 2008. A similar disclosure was included in the financial statements of major U.S. universities such as Yale and Notre Dame that made substantial investments in private equity funds. A member commented that the disclosure was wholly appropriate, especially given that private-market investments were becoming a major area of focus.

  In response to a member's question, Mr. Piché said that the note dealt only with uncalled commitments. The actual amount invested in "private equity and debt funds" was reported earlier in the note.

  Another member observed that, in view of the poor investment returns of some private investment funds, some of their investors had been resisting investing the further amounts committed to those funds. In at least some cases, the managers had initiated legal actions against the investors for failing to honour their commitments.

Among the general matters that arose in the course of the discussion of the notes were the following.

(a) Use of endowed funds in the event of a major, unanticipated need for cash. A member asked about the University's ability, in the event of a sudden unexpected need for cash, either to liquidate endowed funds or to borrow money by pledging the capital of the endowed funds as collateral. Ms. Brown replied that the answer would vary with respect to each of the almost 5,000 individual endowed funds. If a particular fund were entirely unrestricted, its assets could be pledged as collateral. If, on the other hand, the purpose of the endowment was specified, then that purpose had to be respected. The University itself had decided to endow certain funds, which might be available to liquidate or to pledge for collateral. However, in that case as well, it would be necessary to determine whether a legal trust had been established. For example, the University might have used its own funds to match a donation to the endowment and might have undertaken that the matching money would be retained in the endowment and used for its specific purpose. Ms Riggall noted that the Expendable Funds Investment Pool usually contained cash amounting to somewhere

3. Audited Financial Statements for the Year Ended April 30, 2009: Draft Notes (Cont'd)

between $500-million and $800-million. For instance, as at April 30, 2008, the notes showed a balance of $746.3-million. Therefore there was little likelihood of any need to borrow in the foreseeable future.

(b) Investments: Fees paid to agents elsewhere. A member noted that there had been allegations in the United States of agents, who were being paid by institutional investors to seek out good private investments, also being paid *sub rosa* by the fund managers to secure the institution as a client ("pay to play" payments). The outcome had been strict conflict-of-interest guidelines being established by some major institutional investors and the possibility of guidelines being mandated by law. The member urged the consideration of strict guidelines with respect to University investments in private funds. Ms Riggall said that the University of Toronto Asset Management Corporation did not employ agents in seeking out private investments.

(c) Investment: Valuation techniques. A member observed that the value of the University's private investments, and the change in that value, was necessarily determined by valuation techniques "based on assumptions that are not supported by observable market prices or rates." Management believed "there are no other reasonable assumptions for these investments which would generate any material changes . . ." The member asked whether there was any way of clarifying that statement. Ms Riggall and Ms Brown replied that, because a variety of valuation techniques was used for the various types of private-market investments, it would not be possible to provide further clarification in the notes.

In response to the Chair's question, Ms Tory said that the auditors were satisfied with the note disclosures at this time. While other issues might arise as the numbers for the 2008-09 statements came in and as the audit proceeded, there was no area of concern at the present time.

4. Risk Assessment, 2009

The Chair noted 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, and mitigations of, those vital risks considered to be, currently or in the future, more significant and likely to occur, [and] 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. . . "

Ms Riggall reported that the administration had continued to make a number of changes to the report as it was being refined. The administration had planned to roll out the risk-assessment process to the University's Divisions. While there had been some discussion with the

4. Risk Assessment, 2009 (Cont'd)

Chief Administrative Officers of the Divisions, and while there had been some work done on a questionnaire to encourage Divisions to identify their local risks, staff turnover had resulted in the roll-out being placed temporarily in abeyance. Ms Riggall and her colleagues had also given further consideration to the nature of the central report to the Committee. Mr. Mappa had invited her to look at the model used by Mt. Sinai Hospital. In that case, the process was driven by the various committees of the Hospital's Board, which reported to the audit committee on the risk areas that each dealt with. While that did not appear to be the best approach for use at the University, it was the case that the various Governing Council Boards and Committees were responsible for certain areas where the University was exposed to risk, and they did receive reports concerning the management of those risks. Therefore, the risk assessment document had been revised to highlight the reports made to the University's governance committees.

Ms Riggall commented on the report. She would consult to determine the most appropriate means of risk-assessment reporting for the recently established position of Chief Information Officer. A new section had been added to the report dealing with donor and alumni risk. That risk had previously been covered under the more general heading of "reputation/strategic risk." The Report included a section on "environmental and individual health and safety" risk. It had not been included in previous reports because of the substantial separate reporting to the Business Board – both the major annual report and the quarterly reports on compliance with health and safety legislation and policy.

Ms Riggall pointed out that the comments on each area of risk, as recorded by the senior University officer responsible for the particular area, included the comments made for the 2008 assessment as well as the comments added in 2009. Ms. Riggall planned to continue to include two years of commentary in each annual report. The Chair commended the idea, and observed that having the previous year's comments, as well as the current comments, was very helpful.

The Chair also commended the development of the general format of the report. In response to his question, Ms Riggall said that the assessment was used by the Internal Audit Department and was provided to the Audit Committee.

The Committee considered specific aspects of the Report.

5. Report of the Administration

University Credit Opinion

Ms Riggall reported that she had placed on the table the credit opinion of Moody's Investors Service, which had reaffirmed the University's credit rating as Aa1 with a stable outlook.

6. Date of Next Meeting

The Chair reminded members that the next regular meeting of the Committee was scheduled for Wednesday, June 17, 2009. The major item of business would be the review of the audited financial statements.

The meeting adjourned at 5:25 p.m.

______________________________	______________________________
Secretary	Chair

June 10, 2009

51197