AMENDED

UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 87 OF THE AUDIT COMMITTEE

May 28, 2008

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, May 28, 2008 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)
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. Joseph Mapa
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

Regrets:

Ms Dominique Barker

In Attendance:

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

1. Report of the Previous Meeting

Report Number 86 (November 29, 2007) was approved.

ALL ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

2. Audited Financial Statements for the Year Ended April 30, 2008: Draft Notes

The Vice-Chair noted that the full statements would come before the Committee again at the June 18, 2008 meeting, at which time the Committee would consider a motion for approval. Ms Brown and Mr. Piché would, at that meeting, report specifically on any changes to the format or wording of the notes from those now before the Committee. Therefore, while no formal action was required at this time, the Committee should tender any advice on the notes at this time rather than on June 18.

2. Audited Financial Statements for the Year Ended April 30, 2008: Draft Notes (Cont'd)

Ms Brown said that the notes remained in draft form, without the numbers pertaining to the 2007-08 year. Mr. Piché summarized the key changes, which were highlighted by underlining in the text.

- **Changes in accounting policies**. Note 2a), disclosed the implementation of a number of new accounting policies required by the Canadian Institute of Chartered Accountants (C.I.C.A.) concerning financial instruments, including derivatives and hedges. Derivatives were to be recorded on the balance sheet at fair value. The agenda package included a document prepared by Ernst & Young, discussing the new standards in language comprehensible to the layperson. The financial statements would disclose all derivatives, which would continue to be recorded at fair value. The statements would also disclose the use of interest-rate swaps for hedging purposes. For the 2008 statements, the fair value of the swap contract would also be disclosed.

  Page 3 of the notes contained additional accounting policies with respect to disclosure concerning the University's senior unsecured debentures, which were initially recorded at fair value and subsequently measured at amortized cost, using the effective interest rate method. As a result, the valuation of the debentures was subject to interest-rate price risk.

- **Future changes in accounting policy**. Note 2m) on page 4 disclosed future accounting policy changes concerning financial instruments and capital, and it provided an assessment of the impact of those future changes. For the University, the new requirements would require only additional disclosures for 2008-09 but would not affect the reporting of the financial outcome of operations or the University's financial position.

- **Employee benefit plans**. A table on page 5 showed the actuarial assumptions used to measure the University's accrued benefit obligations and benefit cost. They included the discount rate used to determine the accrued benefit obligation for the pension plan and other post-retirement benefit plans. That rate had been increased from 5.25% in 2006-07 to 6.0% in 2007-08, reflecting the increase in the interest rate for high quality corporate bonds. There had also been an increase in the expected rate of compensation increase from 3.75% to 4.25% to correspond with experience.

- **Related parties**. In note 21 on page 17, the statements disclosed the University's relationship with the Tri-Universities Meson Facility (TRIUMF). The disclosure was important because the University had a contingent liability for its share of future decommissioning costs, as disclosed in note 24b). The University was unlikely to be required either to pay that cost or to realize any benefit from its share of this facility.

  In response to questions, Ms Riggall, Ms Brown and Mr. Piché noted that there was some risk of cost arising from environmental damage caused by the decommissioning of this facility, located on the campus of the University of British Columbia. The $6-million estimate for the decommissioning cost was disclosed, but the requirement to make a

2. Audited Financial Statements for the Year Ended April 30, 2008: Draft Notes (Cont'd)

payment was (as noted) unlikely to be invoked. There was no current plan to decommission the facility, and it had a plan to accumulate a sinking fund to pay for the eventual decommissioning. The cost would be reduced by any proceeds from the sale of the remainder of the assets.

- **Transfer to University of Toronto Schools (UTS).** Note 22 on page 17 disclosed the extent of the assets which had been held by the University for the operations of U.T.S. and were transferred to U.T.S. after receiving court approval in August 2007.

- **Termination of relationship with the Canadian Universities Reciprocal Insurance Exchange (CURIE)**. Note 24d) on pages 18-19 disclosed the financial impact of terminating the University's relationship with CURIE, effective January 1, 2008.

  In response to a member's question, Ms Riggall and Ms Brown said that the University had obtained alternative insurance in the commercial market. It would for the time being maintain the same level of deductible.

Discussion arose concerning **accounting for investments**. It was noted on page 7 that the University had income on investments other than those held for endowments whereas it had incurred a loss on the endowed funds. Ms Brown and Mr. Piché replied that the endowed funds, managed through the Long-Term Capital Appreciation Pool, were invested primarily in long-term investments, particularly equities, which had incurred losses during the 2007-08 year. It had been necessary to use monies from the cushion built up from years of highly positive investment returns to make the desired endowment payouts. The other investments were those of operating funds held in the Expendable Funds Investment Pool. Its generally shorter term investments, plus internal loans to University capital projects, had earned a positive return during the year. In response to other questions, Ms Tory said that investments were valued as of their trade date rather than the settlement date (usually three days later). Some investments, particularly those in private pooled funds, could not be valued readily or frequently, and their values had to be based on estimates provided by the external investment managers of the pooled fund.

3. Risk Assessment, 2008

Ms Riggall said that the risk assessment took a somewhat different format for 2008. In 2007, the report to the Committee provided a list of areas of risk and indicated which University officer was responsible for managing each. The Committee had not found a report of that nature to be adequate, and the current year's report therefore followed an enhanced format. Each risk category continued to be assigned to a senior University officer. The report then also looked at the factors contributing to the risk, factors that the University had implemented to mitigate the risk, and comment on changes likely in next short while. It was quite possible that the scope of the report would be enlarged further, in future years, with various major divisions of the University considering their risks and contributions to certain areas of risk management, e.g. financial risk. Ms Riggall noted that the report did not deal with risks related to health and

3. Risk Assessment, 2008 (Cont'd)

safety. The Vice-President, Human Resources and Equity dealt with that area through a major annual report, along with individual reports to any meeting of the Business Board made whenever merited by a particular event. The University had completed a great deal of work in crisis planning and business continuity. A senior officer was on call at all times to take the lead in the event of any crisis situation. The University had participated in a pilot project on business continuity, using software developed at the University of California at Berkley. That software assisted each part of the University to complete business continuity planning. The University had developed a documented crisis-response plan and had participated in a practice session, involving a simulated crisis, with the police, fire department and the Emergency Medical Services. The University had brought into play a United States standard for an integrated approach to crisis management. That standard included a formal way of ensuring that all relevant people within the University knew their roles. That standard also included a hierarchy to ensure appropriate leadership in dealing with any crisis. Ms Riggall stated that, in general, risk was becoming a much larger issue for the world, not for universities in particular. The University of Toronto was working to ensure that it did not fall behind in dealing with risk management. While financial limitations prevented the University from moving to the leading edge on the issue, it was making every effort to ensure that it did not fall too far behind the leading edge.

Among the matters that arose in questions and discussion were the following.

(a) Recent incident at Simcoe Hall. A member asked about the risk demonstrated by the recent occupation of Simcoe Hall by a few student protestors. Ms Riggall replied that the incident had demonstrated certain strengths in the security system for the building. Intelligence systems had proven to be good; the University was able to lock the building down in advance of the occupation. University staff were aware of the action in advance, and there had been no need to call in the Metropolitan Toronto Police to deal with the incident. There had been no harm to any demonstrator; the only injuries had been minor ones caused to certain University employees. The incident had, however, demonstrated certain gaps in the system; the demonstrators had been able to block certain doors open without activating the alarm system. The Toronto Police had decided to lay criminal charges against fourteen of the students involved in the incident, which were proceeding before the courts.

(b) Role of the Internal Audit Department. A member observed that the Audit Committee was charged to understand the University's key controls and processes for controlling risk, and to ensure that they were in place and working well. In so doing, the Committee relied a great deal on the Internal Audit Department. It would be very useful for the Committee to understand which key risks and related controls the Internal Audit Department had and had not examined. Ms Riggall noted that the Internal Audit Department would be concerned with financial and administrative risks and controls. It would not be involved with such areas as governmental / political risk or governance risk. Mr. Britt said that he planned to align his annual report with the categories used in the risk-assessment report. The annual report would deal very specifically with the Department's assessment of risks.

3. Risk Assessment, 2008 (Cont'd)

(c) Management and Committee consideration of risk assessment and management. In response to questions, Ms Riggall said that the report had originated with the members of the University's senior management, who had dealt with their own areas of risk and had then met for a full discussion of the report. The executive group had met to discuss possible gaps in the assessment and the report. It planned to expand the process substantially in 2008-09. A member observed that the format of the report was a very good one. It would be very useful for the Committee to meet with the officers responsible for the key risks at a meeting devoted to consideration of the matter. Another member commented that discussion of the analysis prepared for the Audit Committee could be very helpful in adding a key layer of accountability. The idea of a special meeting would be well worth consideration.

4. Risk Management and Insurance: Annual Report, 2008

Ms Brown recalled that the Committee had been advised that the administration was considering a move from its membership of the Canadian Universities Reciprocal Insurance Exchange (CURIE) to coverage by private-sector insurance companies. She acknowledged the considerable amount of outstanding work completed by Mr. Fleming in the consideration and execution of the change.

Mr. Fleming reported that the University had made a successful transition from CURIE to commercial markets on key property and liability insurance coverage. The timing had proven to be very good, with the insurance market in a very competitive phase. The University had realized net premium savings of $408,000 on property insurance and $248,000 on liability insurance. Adding in Provincial Sales Tax, the University had realized savings of more than $700,000. Initial coverage had been purchased for sixteen months to May 1, 2009 to ensure security of coverage and to provide more flexibility and capacity to negotiate the next renewal to coincide with the beginning of the University's fiscal year. The University had retained all of its core policy terms and scope of coverage, and it had added some small enhancements. The University had used only high-quality domestic and international insurers.

Mr. Fleming said that the University had, most importantly, gained much needed flexibility in customizing coverage and terms to suit institutional needs. The University had been able to reduce some of its insured valuations that had previously been overstated, in particular, the value of library holdings. Previously, CURIE had controlled the annual value calculations and it had therefore been able to increase premiums by increasing insurable values. The process of reducing insured valuations would continue at next renewal and perhaps longer, if needed. In addition, the University had been able to restructure its liability insurance to have limits up to $35-million per loss across all underlying coverages, including our vehicle fleet policy. It had also been able to cap its property policy limit at $500-million per loss, avoiding premium costs for higher limits that were not required. The University had held the property policy deductible at its current level of $250,000 per loss, and it would look at increasing the deductible in the future, if doing so would make sense to offset premium costs.

4. Risk Management and Insurance: Annual Report, 2008 (Cont'd)

Mr. Fleming concluded that the University was very pleased with the results of its reentry to the commercial market. He recognized the excellent work done by the University's new insurance brokers, HKMB Hub International, and the many fine people who worked on the University's behalf.

Mr. Fleming commented on the other facets of the insurance program. The University had enjoyed an excellent year overall with smooth renewals on all its various on-going commercial policies and generally very favourable claims experience across the board. The sole exception concerned the boiler and machinery coverage. The University had made two large claims under that policy, totaling more than $500,000, in the previous policy year, and in January 2008 it had experienced another major failure involving the Co-Generation Plant. The starter gear assembly had failed and the unit had been out of operation for three months, resulting in a net insurance claim of about $1-million. Otherwise, the University's self-insured claims record was good. Those and other details were provided fully in the report.

The Chair observed that the University's claims record had been excellent, with no claims under its fine art and crime policies and no claims likely under its construction policy. He congratulated Mr. Fleming and all concerned on this very good result. Discussion focused on the following topics.

(a) Insurance coverage for the Robarts Library. In response to a member's questions, Mr. Fleming said that in 1988, the Robarts Library holdings had been valued at $850-million, but that amount had been increased substantially by CURIE in the early 2000's. In part, that higher valuation had been caused by the higher exchange rate with respect to the U.S. dollar, but the value had not been reduced as the value of the U.S. dollar had declined relative to the Canadian dollar. The University had objected to the high valuation, which was in part the result of the addition of items to the library combined with the absence of items being removed. But, in part the University believed that the valuation was simply too high. CURIE had initiated an obsolescence study, working in consultation with the Library, and the valuation had been reduced from $1.4-billion to $1.1-billion.

Ms Riggall and Ms Brown added that the Chief Librarian supported the reduction in insurance coverage. In case of any loss, the library books and other materials would be replaced by electronic copies. Certain items such as rare books were literally irreplaceable, and there was no point in carrying large amounts of insurance coverage on them. Even with respect to rare books, the University had digital copies.

A member recalled that the University had constructed a building on its Downsview property for purposes of Library storage. A major worry with respect to the Robarts Library was the absence of a fire sprinkler system, which had been built into the new storage facility. Ms Riggall recalled that even in the Robarts Library, a key concern had been the water damage that would be caused by sprinklers. That issue had been greatly reduced as the result of the digitization of much of the Library's collection.

4. Risk Management and Insurance: Annual Report, 2008 (Cont'd)

In response to a further question, Mr. Fleming said that the insurance coverage of the Library was based on shelf replacement cost. In the event of a catastrophic loss, the insurance would cover losses sustained to the entire building and its contents, up to the maximum insured loss of $500-million.

(b) Insurance of buildings with deferred maintenance. In response to members' questions, Mr. Fleming said that the University reported the replacement cost of buildings to its insurers, who would determine the maximum risk they would insure. A member observed that there was deferred maintenance in many buildings. Would the University, in the event of loss, receive the replacement value for such buildings or would it be limited by the amount of deferred maintenance? Ms Riggall replied that University buildings and their contents were insured to their replacement cost, unless the insurer determined in advance to limit the amount of risk covered. (In the University's case, the maximum coverage was $500 million per loss.) She noted that the University did not carry deferred maintenance liability on its balance sheet. That amount was reported only for information.

The member asked whether the University had considered the possibility of achieving premium savings by deducting the deferred maintenance liability for the insured value of each building. Mr. Fleming replied that the University could insure its buildings on the basis of their actual cash value rather than their full replacement value, but it would have to assume the differential risk in the event of loss. The member said that he understood that the University would wish to rebuild in case of loss.

Mr. Fleming noted that in the event of loss, the University could choose to put in place a functional replacement. For example, the only fire-loss claim submitted from CURIE had concerned a barn in the valley lands of the University of Toronto at Scarborough. The barn had been used for purposes of storage, and the University had chosen to rebuild this storage capacity on the upper level of the campus to have the stored materials more readily accessible.

In response to a question, Mr. Fleming said that the insurers did inspect the buildings they were insuring and made recommendations to improve those buildings in cases where deficiencies placed the buildings at risk. For example, in the case of the co-generation facility, the insurers had added a condition to their insurance: that the University have certain spare parts on hand. One of reasons for the significant time lost by that facility was the time required for the manufacture and delivery of the needed replacement parts. Ms Riggall noted that the University's boilers were inspected regularly by its insurers. Just over two years ago, the University had engaged consultants, Sebesta Blomberg, to inspect its infrastructure. The consultants had found that the infrastructure facilities were well maintained, and they had produced a plan for their ongoing replacement in order to avoid large items of unexpected spending. While the University had not been able to fund the recommended plan fully, it was providing funding and increasing the amount to be set aside.

4. Risk Management and Insurance: Annual Report, 2008 (Cont'd)

(c) Insurance coverage in the event of campus unrest. In response to questions, Mr. Fleming said that the University's insurance coverage contained no exclusions for losses caused by vandalism or fire caused by such actions as student unrest. Should such unrest lead to harm to unionized University staff, resulting in a grievance action(s), the University would be protected as before.

(d) Insurance coverage for business interruption. In response to a question, Mr. Fleming said the University's coverage would not respond to a business interruption caused by a work stoppage by unionized workers. However, if the interruption arose from an insured loss, there would be coverage. He noted that the loss of the use of the Co-generation Plant had represented a business interruption involving the University's machinery, and the University had been insured for that loss.

(e) Insurance coverage for construction projects. In response to a member's question, Mr. Fleming said that the University carried builders' risk and wrap-up liability coverage for its major construction projects. Contractors were not required to purchase coverage for large projects.

The member noted that the cost of decommissioning projects often exceeded their on-going value. Such had been the case with the TRIUMF facility. Was the University covered for those costs? Mr. Fleming replied that decommissioning was not an insurable risk; it did not form a usual part of any insurance coverage. He observed that there was no plan to decommission the TRIUMF facility for many years.

5. University of Toronto Asset Management Corporation: Internal Audit Mandate

Ms Riggall reported that the Board of the University of Toronto Asset Management Corporation (UTAM) had decided to outsource internal audit functions, previously performed on contract by the University's Internal Audit Department, to a larger group with special expertise in the investment business – the audit firm Deloitte and Touche. The internal auditors' mandate had been approved by the UTAM Audit and Compliance Committee and was being brought to this Committee for information. The internal auditors would attend meetings of the UTAM Committee, and they would be willing to attend meetings of the University's Audit Committee, when their presence would be helpful, for example in consideration of the annual reports on the pension plans and the endowment.

In response to a question, Ms Riggall said that UTAM had paid for the services of the University's Internal Audit Department. Using the services of Deloitte and Touche would not have an additional cost. In response to questions, Mr. Britt said that the internal audit mandate, now before the Committee, did not depart in any significant way from that of the Internal Audit Department. The outcome of the termination of the UTAM assignment would have some negative consequences for the Internal Audit Department. While its earnings from the assignment went primarily to recover its costs, there was some gain in terms of the purchase of technology and training that benefited the Department in the execution of its service to the University.

6. Report of the Administration

(a) Endowment Payout

Ms Brown recalled the report, presented in the fall, on the University's endowment funds. Almost all of the endowed funds were invested in a unitized pool called the Long-Term Capital Appreciation Pool (L.T.CAP). The payout to holders of the units had a target of about 4% of the opening market value of the pool. Each year the payout rate per unit was increased by the rate of inflation, provided that the payout remained in a corridor between 3% and 5% of the current value of the units. As a result, in years where the pool earned a good investment return, the University had built up a cushion. The endowed funds had, however, incurred a loss in the past year. Nonetheless, the cushion had enabled the University to increase the previous year's payout by the 2% inflation rate and by an additional 5% to keep the payout at roughly the same place in the corridor. The 2007-08 payout had been $7.65 per unit for a total amount of $62.5-million.

Ms Riggall noted that there had been, over the past winter, a great deal of discussion in the United States suggesting that there be a requirement for a 5% payout from endowments. There had been similar pressure in Canada. It had in fact been useful to be able to point out this year the impact of an investment loss: the University had been able to maintain the payout, the inflation protection and to provide a small increase only because of the substantial cushion that had been built up over the previous four years. Ms Brown noted that the University would be able to seek to maintain a 5% real payout (payout plus inflation protection) only with the adoption of a much riskier investment policy. Such a policy would not be appropriate for a University endowment. In response to questions, Ms Riggall said that the Chief Financial Officer was responsible for the decision concerning the amount of the payout. In the budget assumptions, the University had set out its hope of providing a payout of $7.65. The investment loss had been within a range that permitted that level of payout. If it became necessary as the result of continued investment losses, the University would be able to reduce the payout in the future.

(b) Credit Rating

Ms Riggall reported that Moody's Investors Service had reaffirmed the University's credit rating as Aa1 with a stable outlook.

(c) Audited Financial Statements

Ms Brown reported that the first draft of the University's annual financial statements had been made ready on May 16, 2008 That reflected excellent work by Mr. Piché and his colleagues and by the external auditors.

7. Date of Next Meeting

The Chair reminded members that the next regular meeting of the Committee was scheduled for Wednesday, June 18, 2008. The major item of business would be the review of the audited financial statements.

The meeting adjourned at 5:25 p.m.

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Secretary	Chair

June 10, 2008

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