UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 99 OF THE AUDIT COMMITTEE

June 15, 2011

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 15, 2011 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

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Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy (Vice-Chair)
Professor Ramy Elitzur
Mr. Joseph Mapa
Mr. W. John Switzer
Mr. Chris Thatcher

Ms Catherine J. Riggall, Vice-President, Business Affairs*
Mr. Mark 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:

Mr. J. Mark Gardhouse
Ms Penny Somerville

In Attendance:

Ms Stephanie Chung, 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**

* Absented themselves for item 3(c) and 12.
** Absented themselves for item 4.
*** Absented himself for item 3(c).
**** In attendance items 1 and 2.

ITEMS 3 AND 4 CONTAIN RECOMMENDATIONS TO THE BUSINESS BOARD FOR GOVERNING COUNCIL APPROVAL. ALL OTHER ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

1. Report of the Previous Meeting

Report Number 98 (May 10, 2011) was approved.

2. Risk Management and Insurance: Annual Report, 2010-11

Mr. Fleming said that the 2010-11 annual report was again a good-news report, reflecting the highly positive outcome of the University's move to purchase insurance from the commercial market

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2. Risk Management and Insurance: Annual Report, 2010-11 (Cont'd)

beginning in January 2008. The insurance companies had benefited from good economic conditions in 2010-11, and the insurers continued to offer the University good rates because of its excellent claims record and because of the prestige of the institution. Policies had been renewed as at May 1, 2011 with the same level of coverage and with premiums that were nearly 5% less than those the previous year. Overall insurance premium costs had declined significantly since the University had moved from the Canadian Universities Reciprocal Insurance Exchange (CURIE) to arrange its insurance in the commercial market. The University had in fact achieved further cost savings because of its move as costly claims by continuing members had resulted in CURIE premiums increasing substantially since the University had moved to the commercial market, thereby compounding overall savings.

Mr. Fleming outlined the major insurance policies and the companies that provided them. The University had maintained the same insurers for its property insurance coverage, with a $500-million limit of loss and a deductible of $250,000 per occurrence. For the general liability, errors and omissions, and vehicle fleet policies, the limit of coverage provided by the primary insurer was $5-million. The University had purchased an excess liability policy covering a further $20-million and an umbrella liability policy covering a final $10-million, resulting in overall protection amounting to $35-million.

Mr. Fleming reported that the University had been able both to maintain its desired insurance coverage and to resist pressure for rate increases across all policies and coverage areas. Insurers had been advised of the University's budget constraints, and the University had alternative insurers available if required. The flexibility available in the commercial market had proven to be clearly preferable to the situation of dealing solely within CURIE. Mr. Fleming was very pleased with the program offered by the insurers and was very grateful for the work of the University's insurance brokers, HKMB Hub International Ltd., and its professional staff.

Mr. Fleming reported that renewals had proceeded smoothly on the University's other insurance policies: the fidelity / composite crime policy (with a $25-million limit of loss and a deductible of either $15,000 or $50,000, depending on the category of coverage) and the boiler and machinery breakdown policy (with a $100-million limit of loss and a $25,000 or $100,000 deductible, depending on the category of coverage). Although the University had made some large claims over the years on the boiler and machinery-breakdown policy, the University's experience had apparently improved, with no claims in the recent past. However, after the policy had been put into place with a new specialty insurer, with a significant premium saving over expiry, Mr. Fleming had learned of a serious problem that had occurred during the term of the previous policy, involving a loss estimated to be over $1-million. A raccoon had, in mid-April 2011, climbed onto an out-of-doors power transformer at the SciNet facility and had disrupted a main power feed, causing a voltage spike that damaged complex power supplies to several high-performance computer modules.

Mr. Fleming reported that claims paid from the internal self-insurance reserve had remained approximately consistent with previous years. Those claims covered losses incurred by University

2. Risk Management and Insurance: Annual Report, 2010-11 (Cont'd)

divisions or departments between (a) the $2,500 "responsibility" amount the division or department was required to cover, and (b) the $250,000 deductible amount on the property insurance policy. The University had provided a substantial base-budget allocation to enable the rebuilding of the self-insurance reserve to allow its growth to a level where investment earnings should be sufficient to deal with most claims on an on-going basis.

Mr. Fleming recalled the G20 summit meetings that had taken place in the summer of 2010. The University had taken a number of risk-management steps in the light of problems that might have arisen from activities nearby the St. George Campus. Fortunately, no problems had arisen. 12

Mr. Fleming responded to members' questions.

(a) Damage at the SciNet facility. A member asked about the likely effect of the damage at the SciNet facility on the insurance program for the 2012-13 year and thereafter. In particular, was it likely that the University would be able to maintain the reduction in the premium charged by the new insurer for the boiler and machinery-breakdown policy? Mr. Fleming replied that only a limited number of insurers were large enough to underwrite the University's extensive and complex boiler and machinery equipment against accidental breakdown. Because of the limited competition, claims could prove to be costly for future renewals. In the case of this loss, however, it was unclear what party would bear responsibility. The SciNet project itself was a special design/build project with I.B.M., and it could be argued that that firm should bear some responsibility for the design of the facility resulting in such extensive damage from the problem with the transformer. The out-of-doors power transformer was the property of the landlord for the facility, and it could be argued that the landlord failed in a duty to protect the transformer against the not-uncommon threat posed by raccoons and other vermin. The matter was therefore a complicated one.

(b) Canadian Universities Reciprocal Insurance Exchange. A member referred to the increase in CURIE premiums since the University's withdrawal. Had there been other withdrawals? Ms Brown and Mr. Fleming replied that the University of Toronto had been the only withdrawal to date. Institutions made five-year commitments to CURIE, which would delay any subsequent withdrawals. The University had received some enquiries from other institutions about its experience in the commercial market.

3. Audited Financial Statements for the Year Ended April 30, 2011

The Chair noted that the audited financial statements were before the Committee for recommendation to the Business Board (from there to the Governing Council). The remainder of the *Financial Report* – the "Highlights" and the "Supplementary Report by Fund" – were for information.

3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

Ms Brown thanked Mr. Piché and the Financial Services team, the external auditors and the internal auditors for their extraordinary good work in producing financial statements for Canada's largest and most complex university for consideration by the Audit Committee only six weeks after the end of the fiscal year. That achievement had been possible only through a great deal of hard work at very long hours. Ms Brown said that the financial results for the year represented good news.

(a) Highlights of the Financial Statements

Mr. Piché presented the highlights of the financial statements.

- **Financial statement coverage**. The financial statements included the financial position and results of all operations under the jurisdiction of the Governing Council. That included controlled, separately incorporated ancillary operations with their own boards of directors: the University of Toronto Press Inc. and the University of Toronto Asset Management Corporation. The statements did not include the federated universities (St. Michael's, Trinity and Victoria) which were separate corporate entities. Nor did they include the research conducted by University of Toronto faculty members but administered at the affiliated hospitals.

- **Significant accounting concepts**. Mr. Piché noted that some of the accounting concepts used by the University were different from those used in the business sector. The University followed the accrual method of accounting. Therefore, the amount recorded as revenue was not the same as funds received, and the amount recorded as expense was not the same as funds spent. Expendable grants and donations that were not restricted as to their use were recorded as revenue and flowed through the statement of operations. However, restricted grants and restricted expendable donations were recorded as revenue only when they were spent for their specified purpose. Any unspent restricted grants and restricted expendable donations were recorded on the balance sheet not only as cash but also as liabilities: deferred contributions or deferred capital contributions.

  Donations to the endowment were not recorded as revenue on the statement of operations. Rather they were added directly to the endowments, a component of the net assets recorded on the balance sheet. Similarly, that portion of investment earnings on donations to the endowment that was retained for purposes of preservation of capital was not recorded as revenue. Rather, such earnings were added to the endowments on the balance sheet and recorded on the statement of changes in net assets.

  The University did record amortization of capital projects, and it did record the cost of employee future benefits earned in a given year in accordance with the relatively new accounting rules on that topic.

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3. **Audited Financial Statements for the Year Ended April 30, 2011** (Cont'd)

- **Significant accounting concepts: internal accounting**. For internal purposes, the University recorded its financial transactions using fund accounting. There were four funds: (a) the operating fund for teaching, research and administrative activities, supported mainly by government operating grants, student fees and the sales of supplies and services; (b) the ancillary operations fund for the residences, food and beverage services, parking, Hart House, Real Estate, and the University of Toronto Press; (c) the restricted funds for donations including endowments and for research grants; and (d) the capital fund for capital projects, except those for the ancillary operations. That fund accounting was not displayed in the audited financial statements, but it was presented in the Supplementary Report in the second half of the Financial Report.

- **Key drivers of financial performance and their interdependence.** Key drivers of financial performance included: growth in student enrolment, growth in research activity, growth in salaries and benefits, growth in space, donations, growth in endowments, and investment earnings. Those factors were interdependent. For example, growth in student enrolment would bring about an increase in revenue. But, it would also require an increase in the number of faculty members to teach the additional students, and it would therefore cause an increase in expense. Both students and faculty would require accommodation, which would bring about an increase in spending on capital construction. That would lead to an increase in assets. However, because the University would likely lack full funding for the new facilities, it would also require borrowing, resulting in an increase in liabilities. The proceeds of fundraising would both increase revenue (for expendable donations) and would also increase net assets (for donations to the endowment, which were recorded directly on the balance sheet). Similarly, investment earnings, which could vary substantially from year to year, affected both the income statement and the balance sheet, with earnings on externally restricted endowments used for the preservation of capital (against erosion by inflation) being recorded directly on the balance sheet.

- **Revenues, expenses and net income**. Revenues for 2010-11 had been \$2.321-billion and expenses had been \$2.314-billion – basically a break-even year - with a net income of \$7.2-million. Both revenue and expense had grown steadily over the past ten years, caused by the increase in student enrolment, which increased the University's revenue both from tuition fees and government grants, and the increase in research activity.

- **Financial results compared to forecast**. Each year, early in the calendar year, the administration presented to the Business Board a forecast of the financial results for the fiscal year ending April 30. For 2010-11, the forecasted financial result for the year had been a net loss of \$69.5-million. In fact, there had been a positive net income of \$7.2-million. The most significant variance was underspending of \$77.5-million by the academic and other divisions, which were adding to their reserves.

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3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

- **Revenues**. Revenues had increased to \$2.3-billion. The increase was \$110-million, driven primarily by an increase in enrolment, which resulted in increases in government operating grants and student fees. Government grants received for infrastructure and other restricted purposes had amounted to \$142-million. The University had been fortunate to receive \$91.3-million of funding over the past two years under the Knowledge Infrastructure Program for the construction of the instructional buildings at UTSC and UTM. Research grants had amounted to \$381.2-million, a very significant amount that had remained relatively stable over the past three or four years. Donations had amounted to \$85.1-million, a slight increase over the previous year. Donations continued a trend whereby a higher proportion was directed to expendable purposes and a lower proportion to the endowment. The \$85.1-million did not include pledges that would be fulfilled in the subsequent fiscal year(s). The inclusion of pledges would bring the total of funds raised to about \$100-million, a figure that had remained relatively the same since 2009.

- **Expenses**. Expenses had amounted to \$2.3-billion. The largest factor in the increased expense was compensation (salaries and benefits), which had increased from \$1.319-billion to \$1.460-billion. There had been some increase in expense for scholarships, fellowships and bursaries, from \$132.1-million to \$141.4-million. The other categories of expense had remained fairly stable.

  Expense for salaries had increased from \$1.007-billion to \$1.082-billion. That reflected both increased numbers of faculty and staff, to deal with increased enrolment, and salary increases. It included certain retroactive salary adjustments made during the year in faculty salaries and in pay-equity adjustments for staff. The largest increase in expense in the category was in the non-cash expense for employee future benefits, which rose from \$214.4-million to \$278.3-million, largely because of pension expense. As long-term interest rates had declined, so too had the rate used to discount the future pension liability to the current liability, which had therefore increased.

  In response to a question, Mr. Piché said that the expense for repairs and maintenance had declined from \$92.1-million to \$79.8-million because of reduced grant funding for that purpose.

- **Cash flows**. The University's daily and monthly cash balances had followed a highly predictable pattern since 2002, and they had increased steadily as a result of the growth of the University's enrolment and the level of its funded research activity. The annual peak in cash-flow tended to occur in August and September, when most payments for tuition fees were received. They tended to reach an annual low in June. There had been two sets of unusual movements in cash balances as the proceeds of debenture issues were received and then spent down on the completion of capital projects.

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3. **Audited Financial Statements for the Year Ended April 30, 2011** (Cont'd)

A member observed that contrary to the cash-flow graphs that had been displayed, the Statement of Cash Flows – Statement 4 in the audited financial statements – showed a decline in year-end cash and cash equivalents from $133.1-million in 2010 to $99.3-million in 2011. Mr. Piché explained that the data to which he was referring was broader than the pure cash and cash equivalents shown on Statement 4. The data to which he was referring was the sum of investments in the Expendable Funds Investment Pool (EFIP), as detailed in note 5 to the financial statements. Those investments included short-term bonds and hedge funds.

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- **Balance sheet**. The University's liabilities had increased from $1.253-billion to $1.388-billion. Key elements were the increased pension and employee future benefits liabilities and also the increased deferred capital contribution, representing money received under the Knowledge Infrastructure Program for new buildings but not yet spent as at the fiscal year-end.

  However, assets had also increased, leading to an increase in net assets from $1.800-billion to $1.896-billion. The $96.4-million increase in net assets was primarily the result of the increase in the value of the University's endowments from $1.437-billion to $1.539-billion. The endowment funds had increased as the result of the $64.2-million investment gain on the externally restricted endowments beyond the sum paid out, $21.4-million of externally restricted donations to the endowment, and $3.6-million of restricted grants to the endowment from the Government of Ontario. On the other hand, internally restricted funds had declined from $136.4-million to $90.6-million, primarily as a result of the increase in the unfunded pension liability.

- **Net assets compared to forecast**. In the financial forecast presented to the Business Board on January 31, 2011, it had been predicted that the University's net assets at the end of the fiscal year would be $1.825-billion. Actual net assets had been $1.896 billion. Because of the higher-than-anticipated reserving of funds in the divisions, internally restricted net assets had been $531-million rather than $467-million, as predicted in the forecast. Overall, however, the forecast proved to be reasonably close.

- **Endowment funds**. The University's total endowments amounted to $1.539-billion. The largest portion of the endowments, amounting to $662.0-million, was devoted to student aid. The second largest component, $464.6-million, was in support of Endowed Chairs and Professorships. Other endowments supported particular academic programs and areas of research.

  The largest portion of the endowments was in support of the work of the Faculty of Medicine, followed by the Faculty of Arts and Science, and then the University in

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3. **Audited Financial Statements for the Year Ended April 30, 2011** (Cont'd)

general. The endowment funds not attached to a particular division included the Connaught Fund, which supported research across the University, and supported such other purposes as graduate scholarships.

Looked at on the basis of endowment per full-time-equivalent student, a substantially different picture emerged. The Faculty of Forestry, with a relatively small enrolment, had the largest endowment support per student, followed by the Faculty of Law, the Rotman School of Management, the Factor-Inwentash Faculty of Social Work and then the Faculty of Medicine.

It was an important objective to protect the value of the endowed funds against the erosion of their purchasing power by inflation. For 2011, the University had been able to devote $75.1-million of investment returns to the endowments (net of the $65.8-million payout for the year) to continue the restoration of the inflation-protection reserve. There remained a shortfall of $148.6-million for that reserve.

The investment return on the Long-Term Capital Appreciation Pool, which was the investment vehicle for almost all the endowment funds, had been 9.9% for the 2010-11 year, well above the return target of 6.2% (inflation plus 4%). The target for the volatility of the annual return was ±10% of the target return two-thirds of the time over ten year periods. In the past ten years, the return had been within that range for seven years, above the range once and below it twice.

- **Borrowing**. The University's borrowing strategy defined the maximum permissible external borrowing capacity as 40% of net assets averaged over the previous five years. In addition, the University was permitted to arrange $200-million of borrowing from an internal source: the University's operating monies, which were invested through the Expendable Funds Investment Pool. For 2011-12, the maximum external borrowing capacity would be $773.1-million. The total borrowing capacity would be $973.1-million. In addition, the Governing Council had approved a separate borrowing of $150-million, to be used to help to deal with the large unfunded deficit in the pension plans. The Governing Council had about two years ago, granted approval for the borrowing of $200-million (within the external borrowing limit), but that borrowing had not yet been executed. If that capacity were to be used, actual external borrowing would increase to 38.1% of capacity.

Numerous matters arose in questions and discussion. Among them were the following.

(i) **Divisional reserves**. A member observed that the amount of reserves carried forward by the divisions was $361-million – a very large amount. Ms Brown replied that healthy reserves were very important for the proper financial management of the University and its divisions. Reserves

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3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

were particularly important for the divisions under the current budget model, in which they were expected to generate sufficient revenue, net of overhead, to pay all costs, including the cost of increases to salaries and benefits. Therefore, reserves to smooth the division's financial position were essential. Fortunately, reserving in the academic divisions had been improving substantially since the introduction of the current budget model. Divisions had been urged to develop reserves. Whereas previously many divisions had been in a deficit position, now almost all were in a positive position, able to deal with the risk of (for example) government grants or tuition-fee limits lower than anticipated, special pension-plan contributions, and other unanticipated needs. Ms Riggall observed that some divisions were also building up reserves to meet needs for renovation projects. They would not be able to count on government funding, and borrowing had reached a level very close to its limit. 12

(ii) Cash flows. A member observed that revenues had increased only slightly by $110-million. However, expense for salaries and benefits alone had increased by $140-million. In those circumstances, the member thought that a net income of $7.2-million did not provide a sufficient cushion.

The member observed a number of other worrying facts about cash flows. Cash flows were important: net income represented an opinion; cash represented a fact. The statement of cash flows showed that the cash balance from operating activities had declined from $221.3-million to $155.1-million – more than the $30.3-million decline in net income. Note 18, dealing with non-cash items that would affect cash in the future, showed that the accounts receivable had declined by $3.4-million from the previous year, but accounts payable and accrued liabilities had increased by $13.6-million. Similarly, inventories and prepaid expenses had declined by $5.7-million from the previous year. While Mr. Piché had shown that the daily cash balances were strong and reliable, these additional facts were worrying.

Mr. Piché noted that the most significant element in note 18 concerned capital projects: monies that had been received for projects and owing to suppliers. Another significant element concerned research funding: monies that had been received for research projects but not yet spend were also accounted for as liabilities - deferred contributions. The increase in the items recorded in the note had more to do with the increased funding for capital projects and research activities than unfunded liabilities. The amounts involved as at year-end fluctuated substantially from year to year, and they were largely out of the control of the University.

The member agreed that the University had no doubt invested more in capital projects and had received more funding. Still, at the end of the day, the University had had to dip into its cash reserves to deal with a substantial swing of cash flows. While the amounts concerned could clearly be handled by an institution the size of the University, the fact of the need to have to dip into cash was a matter of concern.

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3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

Mr. Piché did not share the concern. The fact that the University was receiving more funding for capital projects meant that, when the projects were completed, the University would have more invested and there would be a neutral outcome with respect to cash flow. The University's cash balances were sufficient to support the activity sponsored by the additional funding.

A member recalled the presentation made to the Business Board in connection with the recommendation for $150-million of internal borrowing for contribution to the pension plan to reduce its large unfunded deficit. The presentation had demonstrated that the University had a sufficient cash cushion in its Expendable Funds Investment Pool (EFIP) to permit that amount of borrowing. Mr. Piché agreed, but he did recall one cautionary fact. The University's positive cash position arose from the fact that many government grants were delivered in advance of the need for spending them. If, for some reason, there were to be a decline in such grants – for example for capital projects or research – it would then become necessary for the University to borrow the money externally. Ms Brown concurred. There had been a $952-million cash balance at the end of the year, but all of that money had been provided or allocated for a stated purpose: a capital project or a research program or the reserves set aside by a particular academic division. Therefore all of that money would eventually be spent. It was anticipated and hoped that other cash would be provided for other purposes, with a lag time in the need for its spending, to take the place of the current cash amount.

A member commented that the University's liquidity was lodged in its Expendable Funds Investment Pool (EFIP). The EFIP included not only cash but also short-term investments intended to provide some investment return. While those investments were somewhat less liquid than money-market investments, the overall level of liquidity was still very high. Referring to the graph showing the average monthly balances in EFIP by year, the member noted that there had been variation month by month but that the general balance had increased over the years, demonstrating a strong cash position. Another member concurred, with the caveat that the strength of the cash position would depend on the pattern recurring. A third member expressed continuing concern noting, for example, that the balance in EFIP had, beginning in 2004-05, increased at a consistent rate in April, the final month of the fiscal year. That appeared to be highly unusual. Mr. Piché reported that the reason was that the Government of Ontario had provided a special year-end grant in each of those years until 2011.

(iii) Divisional reserves. A member enquired about any process to control the spending of reserves by divisions. Was there risk that unanticipated spending of divisional reserves would put the University's cash position at risk? Ms Brown replied that the current budget model both made divisions responsible to generate revenue and enabled them to spend revenue in excess of their contribution to University overhead and to the University fund (the fund for reallocation to University-wide academic priorities). However, it was unlikely that divisional spending of reserves would catch the centre by surprise. All divisions made detailed presentations of their budget plans to the Vice-President and Provost and a budget committee, detailing their plans with

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3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

respect to all divisional funds. In addition, there were processes required for approval for major items of spending including capital projects and academic appointments. The centre was therefore provided with substantial advance notice of divisional spending plans. Ms Brown noted that divisions were encouraged to make some use of their reserves, especially for programs that were likely to generate additional revenues. Ms Brown was conscious of the need to maintain a strong cash position. That was the reason she had recommended that only $150-million be made available for the loan for the pension-plan contribution. When the EFIP had been established many years ago, the University wished to ensure that it retained a minimum balance of $75-million. At the present time, a much higher minimum balance was thought to be desirable; Ms Brown would be uncomfortable if that balance declined to less than $500-million. Ms Riggall observed that any surprises concerning the financial position of individual divisions were more likely to arise with respect to revenue rather than spending. 12

(iv) Note 24, Comparative financial statements. A member referred to note 24, which stated that there had been some reclassification from the previous year's statements to conform to the presentation of the current statements. Mr. Piché replied that the sole reclassification had concerned about $20-million of revenue for contract research which was now included in government grants and contracts for restricted purposes instead of being shown as a separate line on the statement of operations.

(v) Note 5, Investments. A member enquired about the valuation of difficult-to-value investments. He asked if there any issues of which the Committee should be aware? Mr. Piché said that for private investment interests, the investments were valued by the managers and checked by the custodians and by the University of Toronto Asset Management Corporation. He was aware of no issues that had arisen.

(b) External Auditors' Report on Audit Results

Ms Tory observed that the level of preparedness for the audit of the financial statements had been outstanding. The entire financial report had been available to the external auditors upon their arrival, as had complete working papers. She complimented Mr. Piché and his colleagues on their exceptional work. The entire audit had proceeded very smoothly. The University's activities and its processes had not changed over the previous year, and therefore the audit approach had not changed in any significant way from the audit plan or from the audit in the previous year. As a result of a change in auditing standards, the auditors were not able to sign and date their audit opinion until after the approval of the financial statements by the Governing Council. That would require an extension of the time for review of subsequent events following the completion of the financial statements. Ms Tory did not, however, have any reason to expect that any issues would arise between the present time and the approval of the statements.

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Ms Tory commented on the items of audit significance that had been discussed with management. In some cases, those issues had involved necessary estimates that management had been required to make. In many cases, those estimates had been discussed in 2010, and the matters had been resolved in 2011. In many cases, Mr. Piché had, very helpfully, prepared a complete memorandum setting out the basis for the University's decisions with respect to its accounting for the items. The auditors had discussed with the University officers a number of items of audit significance. Those discussions had not, however, resulted in any differences between the University and the auditors. Ms Tory summarized some of the key items that had been discussed.

- **Special retirement program**. The auditors agreed with the accounting treatment of retirement benefits for eligible members of the faculty and librarians who had applied to retire under the terms of a special program announced by the University in 2010-11. That accounting treatment was an accrual of $5.7-million in the 2010-11 financial statements.

- **Deficits in research accounts funded by restricted research grants**. The Office of the Vice-President, Research had spent a great deal of time dealing with deficits in research accounts, where monies had been spent in advance of payments from the research sponsors. During the year, a total amount of $2.3-million had been written off from accounts that had fallen into deficit in the past number of years. Management had concluded the other balances as at April 30, 2011 were collectible from future cash flows for the research accounts. The auditors had concluded that the University's approach was a reasonable one.

- **Pension plan**. The calculation of the amount currently required to meet the University's future obligations for accrued pension benefits involved an estimate of a very large number. In 2010-11, management had changed one of its assumptions: the interest rate used to discount the future obligations to the amount required at present. The discount rate was based on current interest rates on high-quality, long-term corporate bonds. The discount rate (or assumed earnings on present dollars) had been reduced from 6% per year to 5.6%. At that reduced rate, the amount currently required to meet the accrued benefit obligation was significantly higher. The auditors had agreed that the assumption was reasonable.

- **Liability for outstanding litigation**. The Committee would later on the agenda receive a report on outstanding litigation against the University. Management had made an accrual for potential liability where some reasonable estimate of potential cost was possible. The auditors had reviewed reports from internal and external counsel and had concluded that the disclosure in the financial statements was adequate.

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3. **Audited Financial Statements for the Year Ended April 30, 2011** (Cont'd)

- **Investments**. The auditors had spent a significant amount of time reviewing the value of the University's investments, and especially its $604-million of non-publicly-traded alternative investments. The auditors had, as part of their review, examined the due-diligence procedures of the University of Toronto Asset Management Corporation with respect to the non-publicly traded assets. The auditors had concluded that the investment values recorded were reasonable.

- **Management of research grants.** Funded research was a substantial and growing area in the University, and additional resources had been devoted to the oversight of grant spending. It was a difficult area for oversight in a highly decentralized environment, and management was aware of the need for additional work and resources. Management's approach was to assist principal investigators (the faculty members who held research grants) to understand their responsibilities, the issues involved, and the risks inherent in the area. The objective was to enable principal investigators to get their grant-management decisions right in the first instance to avoid costly remedial action later.

Ms Tory drew the Committee's attention to the report on new accounting and auditing standards. The universities in Ontario were fortunate that the introduction of new accounting standards would require relatively few changes in their financial reporting. They would be able to use the accounting standards for private companies, specially adapted for not-for-profit organizations.

Ms Tory drew the Committee's attention to the "Required Communications" contained in the *Audit Results* Report. She asked members to advise her of, or confirm that they were unaware of, any subsequent events that had not been addressed, any areas of risk that had not been addressed, or any actual or suspected act of fraud that might affect the financial statements or the audit or the statements. Members confirmed that they were aware of no such matters.

(c) External Auditors: Private Meeting

THE COMMITTEE MOVED IN CAMERA.

Members of the administration, the Secretariat and the internal auditors absented themselves. Ms Tory was invited to advise, as provided in the Committee's terms of reference, of "any problems encountered by the auditors, any restrictions on their work, the co-operation received in the performance of their duties by the administration and the Internal Audit Department, and any matters requiring discussion arising from the auditors' findings."

THE COMMITTEE ENDED ITS IN CAMERA SESSION.

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3. Audited Financial Statements for the Year Ended April 30, 2011 (Cont'd)

(d) Legal Claims

The Chair said that the Committee's terms of reference charged it to review "in connection with the review of the University's audited financial statements, an annual report on substantial outstanding legal actions against the University in order to monitor contingent liabilities that should be disclosed in financial statements, as well as . . . to monitor possible risk exposures." The claims included in the report were for amounts that exceeded $300,000.

It was noted that only one new claim had arisen during the year, which was highlighted in the report by underscoring. The amount involved was a relatively small one, and management thought that the University had a strong defence against the claim. It was also noted that many of the claims had originated several years ago and had remained in the report for all of those years.

A member expressed surprise that, for so large an institution, the list of legal claims was as brief as it was and was a cause for so little concern. He asked about any matters that were not reported. Mr. Piché said that the list excluded two types of claims. The first was, as noted, claims by University personnel for such things as long-term disability benefits, pension benefits, etc. Those claims could not be quantified, and they tended to be settled for amounts under the $300,000 threshold. Second, the report included claims in effect at year-end but excluded claims that were settled or otherwise concluded during the year. The member thought that it would be of value for the Audit Committee to know of matters settled or otherwise concluded during the year. The matters could be important from a financial or reputational point of view, and reporting them to governance might well be useful from the point of view of liability risk management. Ms Riggall and Mr. Piché said that they were aware of only three such matters during the 2010-11 year: settlements of two claims in connection with construction projects (where the amounts paid were included in the approved project cost), and the settlement of one claim concerning royalties. Ms Riggall undertook to consider means of providing information to the Committee on legal claims above the threshold that were settled or otherwise concluded during the year.

(e) Committee Recommendation

On the recommendation of the Vice-President, Business Affairs and of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

THAT the University of Toronto audited financial statements for the fiscal year ended April 30, 2011 be approved.

On behalf of the Committee, the Chair congratulated Ms Brown and Mr. Piché and members of their staff on their very well done job in preparing the annual financial statements. He also congratulated and thanked the auditors for their work.

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4. External Auditors: Appointment for 2011 – 12

Ms Brown said that the administration recommended the re-appointment of Ernst & Young as the external auditors of the University's financial statements and those of its pension plans. Ernst & Young audited the statements not only of the University but also of its ancillary operations including the University of Toronto Asset Management Corporation and Hart House. Both the University officers and the officers of the ancillary organizations believed that the firm's performance had been excellent. The University thought that it was particularly fortunate to have Ms Tory as the partner in charge of the University's audit. She was nationally recognized as a leading expert in accounting for the not-for-profit sector. To ensure appropriate objectivity, Ernst & Young, at its discretion, changed the partner in charge of audits for a particular client. The team assigned to the University's audit was also quite experienced, although there was some change from year to year. 12

In response to a member's question, Mr. Piché said that he had three primary reasons for his view that the auditors had been excellent. First, they were very well up to date not only on current accounting standards but also on future ones. They had kept University officers well informed of forthcoming changes and had enabled Mr. Piché to deal with them well in advance and to assist other universities in so doing. Second, the firm was very successful in meeting deadlines; it had rarely faltered in providing responses to requests for information. Third, the teams it had assigned to the University's audits had been very capable and very well experienced; there had been a good level of continuity over time.

On the recommendation of the Vice-President, Business Affairs and of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

(a) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto for the fiscal year ending April 30, 2012; and

(b) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto pension plans for the fiscal year ending June 30, 2012.

5. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2011

Ms Brown said that the annual report focused on the status of the University's Long-Term Borrowing Pool. The University had borrowed money through four fixed-rate debenture issues, with the proceeds to be used for purposes of capital projects. The University provided loans to individual projects. The divisions that taken out those loans were required to make payments of blended principal and interest. The proceeds of those payments were used by the University to make twice-annual payments of interest on the debentures and to cover other costs. The remainder was accumulated in a sinking fund – the Long-Term Borrowing Pool – which would be used to repay the bullet debentures when they become due between 2031 and 2046. The

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5. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2011 (Cont'd)

sinking fund was invested in the Long-Term Capital Appreciation Pool (the L.T.CAP), – the same pool that was used for the investment of the endowment funds. The Long-Term Borrowing Pool was in better condition than it had been one year previously. Following the L.T.CAP's large investment loss in 2009, there had been a significant recovery in 2010. There had, in addition, been a substantial amount of further monies invested arising from continued repayment of internal loans. The Long-Term Borrowing Pool, as at April 30, 2011, had assets of \$88.7-million and liabilities (principal collected to date and payable to debenture owners on the debentures' maturity dates) of \$91.9-million.

A member observed that the Business Board had approved a separate borrowing capacity of \$150-million for purposes of contribution to the pension plan to reduce its unfunded liability. However, borrowing to date had been only \$112.6-million. Ms Brown explained that the University had made a \$150-million special contribution to the pension plan, but it had used the pension reserve to fund part of that contribution. The administration would determine when it would be best to use the remainder of the borrowing authority for a further contribution.

6. Report of the Administration

Ms Riggall reported that the University had received a letter from the Financial Services Commission of Ontario enquiring about investment expenses. Apparently, the University's investment expenses ranked in the 95th percentile. The Commission had asked why the expenses were so high and what steps were being taken to reduce them. The University of Toronto Asset Management Corporation (UTAM) was preparing a response. A substantial part of the reason for the high cost relative to the value of the assets was the decline in 2008 and 2009 in the value of the assets. The actual costs consisted mostly of the fees paid to the external investment managers; UTAM's internal costs were quite reasonable. UTAM, under its new management, had been taking steps to achieve a major reduction in the fees paid to the external managers. At the same time, the value of the assets had been increasing. Therefore, the costs relative to assets would be significantly improved going forward.

7. Date of Next Meeting

The Chair reminded members that the Committee's first regular meeting for 2011-12 was scheduled for Wednesday, December 7, 2011 at 4:00 p.m..

8. Internal Audit: Annual Report, 2010-11

Mr. Britt reported that the Internal Audit Department's staff complement over the 2010-11 year had been consistent with plan. The Department had provided 109% of the audit hours projected in the plan, arising from: the need for substantial overtime hours to complete two

8. Internal Audit: Annual Report, 2010-11 (Cont'd)

lengthy special reviews; additional assistance provided to the external auditors to deal with their program of reviews of capital projects (given the heavier load of projects in the year); and the need to compensate for the recurring illness of one senior auditor.

Mr. Britt commented on the stages of departmental reviews. They began with a detailed risk assessment, leading to the development of the focus and scope of the audit. The internal auditors then proceeded with the audit. Audits described in the report as being in process could be anywhere between the detailed planning stage until the presentation of a draft report. When an audit had proceeded to the stage of a draft report, that report was with the auditee, awaiting the unit's response and action plan to deal with needs identified in the audit. The unit's response was included in the final report. 12

Mr. Britt drew members' attention to Schedule 1, which listed the audits according to their state of completion: in progress, draft report, completed. The eight completed reviews had ranked the units' controls. In seven cases, the controls and processes were ranked as adequate, but in one case they were ranked as "needs improvement." In the case of a review leading to a ranking of "needs improvement, a follow-up review was scheduled earlier than the usual follow-up review that would take place between six and twelve months after the issue of the final report

Mr. Britt said that the risks and risk indicators identified in the departmental audits were shown in Appendix "A". The Appendix listed each category of risk that appeared in the University-wide risk-assessment profile and the factors or controls that could mitigate the risks in the category. The Appendix then listed the indicators of the risk found in the one or more of the year's audits, and it listed the units in which those one or more of those risk indicators had been found. Two members asked what conclusions the Committee should draw from the Appendix. The list of risk indicators was a long one in each risk category, as was the list of units in which those risk indicators were found. Should that be a cause for the Committee to be concerned? Mr. Britt replied that for each risk indicator, procedures or steps to mitigate risk were in place for the University, but they were not being carried out adequately in at least one of the units listed. The observations of such risk indicators was the basis of the Internal Audit Department's conclusion that the unit's carrying out of procedures and controls was adequate or needed improvement. The Department's overall conclusion was that, in those units ranked as "adequate," the Committee could conclude that, notwithstanding one or more concerns about particular risks, there was overall no need for concern. In the unit ranked as "needs improvement," there was cause for concern and need for action to be taken by the unit to effect improvements. The Appendix was not meant to convey an overall assessment of the effectiveness of procedures and controls across the University.

A member observed that in 2010-11 the Internal Audit Department had devoted only about 2% of its audit hours to information-systems audits. However, information systems had been described as a very important area of risk. Mr. Britt replied that the Department's ability to

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8. Internal Audit: Annual Report, 2010-11 (Cont'd)

devote time to any particular area was contingent on its need to complete work in other areas. The Department's primary work in the systems area had been the service of one of its Audit Managers, who was a certified systems auditor, on the Information and Technology Services Middle Table Governance Committee. That service kept the Internal Audit Department informed of developments in the University's information-systems environment. There had not been a substantial amount of activity requiring a focus of attention from the Internal Audit Department in 2010-11. In 2011-12, however, there would be need for a project-management assessment for the development of the Next Generation Student Information System. The Internal Audit Department would be involved from the outset in the development of that system.

Mr. Britt reported on the details of the audit that had reached the conclusion that administrative matters in a particular unit needed improvement.

9. Internal Audit Plan, 2011-12

Mr. Britt presented the Internal Audit Plan for 2011-12. The plan projected 8,300 direct audit hours from a full-time-equivalent staff complement of 7.5. The audit hours projected represented an increase from the 2010-11 plan, although a reduction from the actual hours provided in that year. The increase had been achieved in spite of a small reduction in complement. It had been achieved by a reduction in the number of hours devoted to administrative work and a reassignment of those hours to audit work. Mr. Britt noted that a recent resignation in the Department would give him the opportunity to re-examine the service model for the Internal Audit Department, with the object of determining how it could deliver the best value within its budgetary ability. He would report further on the matter in the fall. One matter that would require particular consideration was the time required for special reviews. In the Internal Audit plan, he had divided special reviews into two categories: (a) investigations of allegations of impropriety, and (b) advisory services to assist units with problems. The latter category could range from responses to informal telephone enquiries to more complex reviews of processes.

Mr. Britt said that the activities included in the plan for 2011-12 sought a balance among reviews of academic divisions, student-service operations, and central administrative operations. Units for review had been selected on the basis of two criteria: application of the risk-assessment categories in the risk-assessment profile and requests from senior administrators. The plan included time for Mr. Britt to make his presentation on prevention of fraud to appropriate staff in the central and divisional Human Resources offices and in any academic and administrative divisions that might request it.

Among the matters that arose in discussion were the following.

(a) Internal audit services for the University of Toronto Asset Management Corporation (UTAM). A member recalled that UTAM had decided to outsource internal audit services from

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9. Internal Audit Plan, 2011-12

a specialized team from the accounting firm Deloitte Touche. The member asked whether the Internal Audit Department received copies of reports from the firm. Ms Riggall replied that such reports were at present sent only to the UTAM Board and UTAM management, but she would arrange that copies be sent to Mr. Britt.

(b) Continuous auditing. A member asked for Mr. Britt's assessment of the value of the continuous auditing program. A significant amount of time was dedicated to the program, and most of the findings consisted of the discovery of simple errors. Notwithstanding the surveillance, the rather high error rate appeared to be continuing. It appeared that the requirement for approval by an officer at one level up was not functioning as well as hoped. Mr. Britt replied that the most important benefit of the program was making staff members across the University aware that their transactions were subject to auditing. That awareness was quite apparent in training sessions and other conversations. While the continuous auditing process was not necessarily the best use of the auditors' time, and while the work might well be performed by lower level staff, the function did have to be performed. Apart from the continuous audit process, there was only limited review of certain kinds of transactions by the Financial Services Department and the Procurement Department. The process of one-level-up countersignature could not be counted on to eliminate simple error. Error should however, be eliminated by the business officer or the administrative assistant at the stage of reconciling accounts. 12

Ms Brown said that she placed a very high value on the continuous auditing process. Its value was not simply in checking for errors. Its major value was in the prevention of fraud in a decentralized environment in which a large number of staff members were processing transactions. It was very important that staff be aware that those transactions were being monitored. The fact that continuous auditing was taking place was also very useful in protecting confidentiality where staff members made allegations of impropriety. The examination of the relevant transaction(s) could be ascribed to the continuous auditing process rather than to the allegation of the other staff member. That again was very useful in encouraging reports of impropriety and preventing fraud.

10. George E. Myhal

In the course of the proceedings, the President joined the meeting to thank Mr. Myhal for his extraordinary service to the University – particularly his service over the past eight years as Chair of the Audit Committee. Mr. Myhal had been a pillar of the alumni of the Faculty of Applied Science and Engineering and a great citizen of the University of Toronto. The Committee endorsed the President's thanks with its applause.

Later in the meeting, Ms Riggall, on behalf of the Committee, also thanked Mr. Myhal for his much appreciated service as Chair over the past years. The University and the Committee were very grateful. In the tradition of the Governing Council, she presented Mr. Myhal with a

10. George E. Myhal (Cont'd)

University of Toronto Captain's Chair, inscribed to commemorate his service. The Committee again endorsed this expression of gratitude with its applause.

11. Chair's Remarks

The Chair thanked the President, Ms Riggall and members for their kind remarks. He had served on many boards and committees, and he had most enjoyed serving on the University's Audit Committee. The Committee performed its work very well. That was in large part the result of the work of a highly competent, diligent, consistent and experienced management team, which was entirely open to discussion. He had never felt constrained in any way in raising any matter. It was equally the result of the exceptional members who had participated in, and contributed to, the work of the Committee. Ms Tory had contributed enormous knowledge of accounting for not-for-profit organizations and excellent judgement, and Mr. Britt had proven to be a pillar of strength. The Chair had been very pleased to be a part of the Committee.

12. Internal Auditor: Private Meeting

THE COMMITTEE MOVED IN CAMERA.

Members of the administration, the Secretariat and the external auditors absented themselves. The Committee met privately with the Director of the Internal Audit Department. Mr. Britt was invited, as provided in the terms of reference, to report on "any problems encountered, any failure to provide appropriate information or any restrictions on internal audit work, the general cooperation received in the performance of internal audit duties, and any matters requiring discussion arising from the auditor's findings.

THE COMMITTEE CONCLUDED ITS IN CAMERA SESSION.

The meeting adjourned at 6:20 p.m.

Secretary　　　　　　　　　　Chair

September 14, 2011

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