UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 84 OF THE AUDIT COMMITTEE

May 28, 2007

To the Business Board,
University of Toronto.

Your Committee reports that it met on Monday, May 28, 2007 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Ms Paulette L. Kennedy (In the Chair)
Ms Dominique Barker
Mr. Gerald A. Lokash
Mr. Richard Nunn
Professor Gordon Richardson

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
Ms Cristina Oke

Regrets:

Mr. Paul E. Lindblad
Mr. George E. Myhal
Mr. Robert S. Weiss

In Attendance:

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

ALL ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

1. Report of the Previous Meeting

Report Number 83 (November 6, 2006) was approved.

2. Audited Financial Statements for the Year Ended April 30, 2007: Draft Notes and Revenue Recognition

Ms Brown invited the Committee to review the planned wording for the notes to the financial statements. Changes to the wording from the previous year were shown; the numbers for the current year were not yet given. The Committee was asked also to review (a) the proposed recognition of certain revenue from the Government of Ontario and (b) the proposed classification of certain capital fund items.

2. Audited Financial Statements for the Year Ended April 30, 2007: Draft Notes and

Revenue Recognition (cont'd)

Mr. Piché said that there were only two substantial changes to the wording of the notes.

- **Note 4, Investments**. The note included disclosure of the University's entry into electricity swap agreements to fix the price of electricity into the future, removing the risk of future fluctuations in electricity rates for a portion of the University's electricity needs.

- **Note 11, Series D senior unsecured debenture**. The new note provided information about the $75-million debenture issued in December 2006.

All other changes were minor.

Mr. Piché said that when the University received a grant in a given fiscal year with no restrictions as to its use and no accompanying requirement to report as to its use, it recognized the grant as revenue in the particular fiscal year. When, on the other hand, there were specific restrictions as to the use of the grants, the amounts were either (a) recorded upon receipt as deferred contributions and were taken into revenue as the money was expended for the purposes of the deferred contribution, or (b) recorded upon receipt as deferred capital contributions and taken into revenue as the capital asset obtained was amortized over time. The Committee was informed of the very welcome receipt of certain grants in March 2007 from the Government of Ontario. The correct accounting treatment for certain of those grants was ambiguous. After discussion with the Ontario government, it was agreed that the proposed accounting treatment for each of those grants, as presented to the Audit Committee, was appropriate.

Mr. Piché reported on the discovery of a non-material misclassification in the accounting for certain capital assets during a review of the University's accounting for the capital fund to seek out simplifications and streamlining. Beginning in 1998, new accounting rules required that capital assets acquired with unrestricted funding be accounted for on the balance sheet as investment in capital assets and the amount reduced over the life of the asset as it was amortized. Capital assets acquired with restricted funding were to be accounted for on the balance sheet as deferred capital contributions, again reduced over the life of the assets as they were amortized. The University had, since the rule came into effect in 1998, accounted for certain capital assets in the capital fund as deferred capital contributions because in its prior experience virtually all capital funding was restricted. In fact, since that time, some capital assets had been acquired with unrestricted funding. As a result the deferred capital contributions, which totaled $596.4-million as at April 30, 2006, were $26-million higher than they would have been according to the correct classification and the investment in capital assets was $26-million lower. The correct accounting was being adopted for the 2007 financial statements, but the University proposed not to restate its financial statements to correct this non-material misclassification for previous years. Ms Tory said that the external auditors concurred with that decision given the immaterial amount, which would decline over the years as the assets were amortized.

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

2. Audited Financial Statements for the Year Ended April 30, 2007: Draft Notes and

Revenue Recognition (cont'd)

(a) Note 4, Investments. Members observed that the description of the University's derivative financial instruments included electricity swap agreements to fix the price of a portion of the University's electricity supply and interest-rate swap agreements to hedge the interest paid on long-term debt. The inclusion of those swap agreement in the "investments" section might cause confusion. Ms Tory suggested that it would be worth considering placing the information about those derivative instruments in a separate note rather than including them in the note on investments.

(b) Note 3, Employee benefit plans. In response to members' questions, Mr. Piché said that the discount rate used to calculate the accrued benefit obligation for pension and other post-retirement benefit plans was set using current long-term bond rates. Ms Brown noted that the change in the assumption concerning the rate of compensation increase, which had been increased from 3.75% to 4.25%, reflected the actual rate of change. The rate of increase included two components: an across-the-board component, which reflected increases in the cost of living, and merit and step increases for staff and progress-through-the ranks increases for faculty.

In response to a question about the effect of new accounting rules for benefit plans to come into effect for the 2007-08 year, Ms Tory said that the full pension plan deficit would be recorded as a liability, directly reducing net assets. The actuarially computed cost of benefits earned in the year would continue to be recorded as expenses, as would actuarial gains or losses, past service costs arising from plan amendments and transitional assets/obligations, all amortized over the average remaining service life of employees. In response to a further question, Ms Riggall said that the likely reduction in the University's net assets arising from this change would not affect the University's debenture debt, which included no covenants. It would reduce its borrowing capacity, limited by Governing Council to a maximum of 40% of net assets averaged over the past five years. However, Ms Brown added that the University's currently outstanding external debt was less than 26% of its net assets. In the application of the five-year average, a year with particularly low net assets would cease to be included next year, reducing the risk of a problem arising from the application of the new accounting rule.

3. New Accounting Rules for Financial Instruments: Application for the 2007-08 Year

Mr. Piché said that the Canadian universities had sought to achieve consistency in their application of the new accounting rules for financial instruments. The University of Toronto and the majority of universities would classify their financial instruments as being "held for trading." That classification would require very little change for the University of Toronto. The University currently recorded its financial instruments at fair market value, with both realized and unrealized gains in the value of those instruments being recorded on the income statement.

Mr. Piché reported that the University was continuing work with respect to one aspect of the new rules: the review of contracts to determine whether any contained embedded derivatives – terms in the contract that would require a change in the price of the contracted goods or services in response to changes in a specified rate, price, index, etc. No such embedded derivatives had been found to date. A member said that it would be useful for the Committee to receive a brief report on the process used to search for embedded derivatives.

3. New Accounting Rules for Financial Instruments: Application for the 2007-08 Year (cont'd)

In the course of discussion, Ms Brown thanked Mr. Piché for his leadership at the national level with respect to the application of the new accounting rules for financial instruments by Canadian universities. As the result of Mr. Piché's leadership at the Financial Reporting Committee of the Canadian Association of University Business Officers, a high level of consistency among Canadian universities had been achieved on this matter.

4. Risk Assessment Profile, 2007

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

> an annual management report on significant business, financial and regulatory risks and [to] monitor the University's processes for identifying and controlling those risks. In carrying out this responsibility, the Committee focuses primarily on the adequacy of key controls over those vital risks considered to be, currently or in the future, more significant and likely to occur, 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.

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

Ms Riggall said that the 2007 report was significantly different from the reports in previous years, which contained a detailed list of specific risks with a ranking of the probability of their occurrence and their potential impact. Both members of the senior administration and members of the Audit Committee had expressed concern about the amount of detail in the previous reports. The administration had classified risks into broad categories and had identified a very senior officer to assume responsibility for each category. The risk assessment and controls were examined carefully at three meetings of the University's senior executive group (the President and Vice-Presidents' group) and each officer was asked to attest that appropriate controls were in place in the officer's area of responsibility and that she/he was prepared to be accountable for the management of the risk in the area.

Ms Riggall said that she planned to add further information to the report for 2008, including: (a) a list of policies, procedures and protocols that contained risk controls; and (b) a list of regular reports to governance on risk control, such as the regular reports to the Business Board on compliance with health and safety regulations.

Two members, while understanding that less detail was appropriate, still expressed concern. Legally, the Governing Council had to assume responsibility for risk management, and it was usual in a corporate environment that the Board signed off on the risk assessment and report on risk controls. One member observed that no single individual, however, able, could deal with risk management in a broad area in so complex an institution. Had there been real consideration of the risk, including challenge and discussion, in the University's executive group?

4. Risk Assessment Profile, 2007 (cont'd)

Ms Riggall assured the Committee that substantial discussions had been carried out. Ms Brown recalled that the formal risk-assessment process had now been in place for several years, and that detailed listings of risks, controls and mitigation strategies had been provided in previous years. That work had demonstrated that there were numerous policies, procedures and processes in place to control risks.

The Chair said that the Committee's duty was to be sure that the administration was carrying out active monitoring and control of risk, and the Committee had been advised that this was the case, with risk-management having been considered at three meetings of the senior executive group.

A member said that he had been, as a result of the previous year's report, confident that there was an active program of risk assessment and control in place. With much less information, he was much less confident this year. Ms Riggall noted that the previous year's report had identified few risks with a relatively high probability of occurrence. The member hoped that more information would be made available next year. If a detailed written report was not appropriate, there should at the least be a detailed oral report. Legal responsibility resided with the Governing Council, and the Council or its Audit Committee had to be kept fully informed.

In the course of discussion, a member noted that the work of the external and internal auditors were listed in the report among the factors that controlled risk. Ms Tory said that the external audit process was one of several processes that helped to control financial risk. In practical terms, the external audit process played a substantial role primarily in the control of financial reporting risk. Mr. Britt said that the internal audit process monitored controls at a "micro" level, focusing primarily on divisional and departmental compliance with financial policies and procedures. Internal Audit did not test the effectiveness of higher-level processes. In response to a question, Mr. Britt said that he had not been involved in the overall risk-assessment process in the current year. A member suggested that the Internal Auditor become involved in that process.

5. Risk Management and Insurance: Annual Report, 2007

Mr. Fleming stated the objective of the insurance-related risk-management program was to respond to the University's insurable risks in a financially prudent way. The program had done reasonably well over the past year. There were two primary financial elements to the program: the risks insured through the Canadian Universities Reciprocal Insurance Exchange (CURIE) and the risks insured through the commercial insurance market.

With respect to CURIE, Mr. Fleming said that the organization had just completed the third year of a major financial reorientation. Based on actuarial advice, CURIE had reconstructed its rate structure, increasing rates by another 24% for 2006 after 30% increases for each of the previous two fiscal years. However, for the next fiscal year, the increase would be only about 5½%. CURIE's financial health had now improved, and its surplus of assets over liabilities had increased to $16.5-million at the end of 2006, an increase from $11.2-million in 2005 and $6.0-million in 2004.

5. Risk Management and Insurance: Annual Report, 2007 (cont'd)

In the commercial market, Mr. Fleming said that the cost of policies had remained level or had even in some cases declined by up to 10% - 15%. The property and casualty insurance industry in Canada was faring well, having earned a return on equity of 18.5% in 2006 so the commercial insurance market was now very robust.

Mr. Fleming reported that the University's claims experience had been quite good for a very large institution with a very large asset base. It was comforting that the claims against the property insurance policy for damage from such things as water, smoke, fire and windstorm had averaged only about $300,000 per year. The $250,000 deductible for each property claim was handled by the University's self-insurance reserve, after a $2,500 charge against the division or department incurring the loss. That arrangement shielded the departments from debilitating costs. The University had had to make two substantial claims on its boiler and machinery policy. The largest had arisen from the loss of a large cooling chiller at the University of Toronto at Mississauga. That chiller had been scheduled for replacement at the end of the summer of 2006 and a replacement had been ordered. The old chiller, however, had exploded at the beginning of the summer, leading to a $400,000 insured claim. The University's record with respect to claims on that policy had been excellent for the eight years prior to 2006. Other significant claims required against the property policy were from substantial water damage caused by the accidental discharge of fire sprinklers. In two cases in high-rise student residences, mechanical damage to sprinklers had caused water discharge. In the new Morrison Hall residence in University College, such an incident had caused $150,000 of damage. Another in Woodsworth College had resulted in $30,000 damages. The largest claim in 2005 had arisen from weather-related damage at the University of Toronto at Scarborough. Fortunately, there had been no further problem of that nature there in 2006. Recently, there had been storm damage at the David Dunlap Observatory in Richmond Hill, when a strong wind had caused a tree to fall on the gate-house, which, fortunately was unoccupied at the time. There was, however, $65,000 of structural and other damage to the premises.

Mr. Fleming reported the need to make three claims arising from damage to vehicles driven by graduate students completing field research at sites off campus. In all cases, the nature of the research meant that the vehicles were being driven off usual roadways, in one case on snow and ice in the Yukon. Very fortunately, no personal injury had been incurred in any of the cases, but the vehicles themselves – two rented and one University-owned - had to be written off completely. Mr. Fleming was working with the departments involved to institute better risk management processes.

Going forward, Mr. Fleming said that the current contract with CURIE would end as at December 31, 2007. The University had not yet reached a decision whether to enter into another five-year contract. Mr. Fleming anticipated that the new contract, if it was entered into, would be on substantially the same terms and conditions as the current one. He was currently examining the alternatives offered by the commercial marketplace.

A member noted that when CURIE had been established, there was no acceptable commercial alternative. Was there a viable alternative at this time? The member also asked the implications to CURIE should the University decide not to enter into a new contract.

5. Risk Management and Insurance: Annual Report, 2007 (cont'd)

Mr. Fleming replied that he was confident that a commercial alternative to CURIE coverage was now available. Ms Brown added that when CURIE was formed, the University of Toronto was considerably smaller, and its capacity to attract coverage specific to its needs was much more limited. At this time, however, the University's size made it much more able to obtain the coverage it required in the commercial marketplace. There were currently 55 universities in CURIE, and the University of Toronto represented only 8% of its premium income. The University had been working with CURIE for several years on a number of concerns that went well beyond the amount of its premiums, but there were still several outstanding issues. The University of Toronto had done its part for CURIE. Having said that, Ms Brown stressed that no decision had yet been taken to renew the CURIE agreement for a further five years.

6. Report of the Administration

Ms Riggall said that a draft of the 2007 *Financial Report* had been completed, and she was confident that the Committee would be pleased with it. She had thought it remarkable that the draft financial statements for so complex an institution could be completed by May 18, less than three weeks after the end of the fiscal year. She thanked and congratulated Mr. Piché and his colleagues.

7. Date of Next Meeting

The Chair reminded members that the final regular meeting of the academic year was scheduled for Wednesday, June 20 at 4:00 p.m. The major item of business would be the review of the audited financial statements.

A member asked that the Committee consider beginning its meetings again at 5:00 p.m.

The meeting adjourned at 5:05 p.m.

Secretary	Chair

June 13, 2007