UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 89 OF THE AUDIT COMMITTEE

December 3, 2008

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, December 3, 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)
Ms Dominique Barker
Mr. Paul E. Lindblad
Mr. Joseph Mapa

Ms Catherine J. Riggall,
Vice-President, Business Affairs

Mr. Mark L. Britt, Director,
Internal Audit Department
Ms Sheila Brown, Chief Financial Officer
Mr. Louis R. Charpentier, Secretary
of the Governing Council

Mr. Neil Dobbs, Secretary

Regrets:

Professor Ramy Elitzur

In Attendance:

Professor Angela Hildyard, Vice-President, Human Resources and Equity
Mr. Pierre G. Piché, Controller and Director of Financial Services
Mr. Allan Shapira, Hewitt Associates
Ms Martha Tory, Ernst & Young
Mr. Bernie Yeung, Ernst & Young

1. Chair's Remarks

The Chair welcomed members to the first meeting of the year. He noted that the Committee met in closed session and it received a great deal of written material of a highly confidential nature. Some items would become public after the Committee had dealt with them, such as the University's financial statements. Other material, however, had to remain private, for example the Internal Auditor's plan. Members were therefore asked to treat the information they received, and the Committee's discussions, with a high level of discretion.

2. Report of the Previous Meeting

Report Number 88 (June 18, 2008) was approved.

REPORT NUMBER 89 OF THE AUDIT COMMITTEE – December 3, 2008

THE FOLLOWING ITEM CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD FOR APPROVAL

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2008

Ms Brown noted that the annual report on the pension plans was being presented in its current format for the second year. It included a comprehensive explanation of the operation of defined-benefit pension plans in general and the University of Toronto's plans in particular. The University had three pension plans: the main registered plan, the registered Ontario Institute for Studies in Education pension plan (the plan for members of the staff of OISE before its merger with the University), and the Supplemental Retirement Arrangement (the S.R.A. to provide supplementary pensions for plan members whose earnings exceeded those that would result in the maximum pension under the Income Tax Act). In addition to the textual information, the report included summaries of the actuarial reports on the plans and the audited financial statements on the main registered plan and the OISE plan. Ms Brown summarized the highlights of the annual report. She noted that she would update the report by providing information on the market value of the assets as at October 31, 2008, which would provide the most recent reliable information available on the effect of the sharp decline in the securities markets since July 1.

- **Operation of defined-benefit pension plans**. The liabilities of the plans depended on the number of participants, their years of service, their salaries, the plans' benefits and certain assumptions built into the valuation of the plans concerning matters such as life-span and rate of salary increase. The liabilities of the plans represented their needs in order to make pension payments. The plan assets arose from only two sources: (a) employer and employee contributions, and (b) investment earnings. From those sources were deducted the cost of pension payments and fees and expenses. The difference between the value of the assets and the amount of the liability determined the market surplus or deficit in the pension plan.

- **Tools for the assessment of the pension plans**. All of the various tools for assessing the value of the plans were included in the report. First, the financial statements for the registered pension plans provided an audited value for their assets as at June 30, 2008. Second, the report included the three funding valuations prepared by the actuaries. The first valuation was the going-concern valuation. That was the valuation used throughout the text of the report in the light of the assumption that the University would remain a going concern whose operations would continue indefinitely. The second valuation was the solvency valuation prepared by the actuaries in accordance with the requirements of the Financial Services Commission of Ontario. It examined the status of the plan as it would have been had it been wound up as of July 1, 2008 and had the University purchased annuities or made cash settlements to provide the promised benefits, apart from partial indexation. The third valuation was a wind-up valuation, again based on the premise that the plans were wound up as of July 1, 2008 and annuities purchased or lump sum payments made to provide all benefits, but in this case including the partial indexation. The final tool was the accounting valuation included in the University's own audited financial statements. There was always a considerable discrepancy in the numbers in the University's audited financial statements and in this report. That was the case for

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

two reasons. First, the University's audited financial statements were prepared as at April 30 and the pension plan financial statements prepared as at June 30. Second, while the pension-plan actuarial reports and the annual financial report took into account the assets set aside by the University to meet its obligations with respect to the Supplemental Retirement Arrangement, those funds were accounted for separately in the University's audited financial statements and not included in the pension numbers, in accordance with accounting requirements.

- **Pension funding status as at July 1, 2008**. As at July 1, 2007, the main registered pension plan had enjoyed a surplus in the market value of its assets of $184-million above the amount of its liability. Adding in the surpluses in the other plans, the overall position of the University's pension plans was a market-value surplus of 7% above the total of the plans' liabilities. For 2008, the situation had reversed. The main registered plan was in a deficit position amounting to $165-million as at July 1, 2008. Taking into account the surpluses in the OISE plan and in the funds set aside for the Supplemental Retirement Arrangement, the overall picture was a deficit in the market value of the assets amounting to 4% of the combined liabilities. That represented the starting point for the sharp decline in the value of the assets in the securities-market deterioration after July 1.

- **Liabilities**. The liabilities of the plans had grown steadily, nearly doubling over the past ten years, with the liabilities of the main registered plan being $2.890-billion as at July 1, 2008. Over the past year, the liabilities of the main registered plan had increased, while those of the OISE plan (which plan was closed to new entrants) had declined. The number of participants in the registered plan had grown by 526, while the number in the OISE plan had declined by 30. There had been no benefit improvements during the past year and no changes in the actuarial assumptions.

- **Assets**. Looking at the assets for the past ten years, there had been an increase in their value until 2001, when the securities markets had declined. The assets had then increased again from 2003-04 to 2006-07, with a decline following in 2007-08, reflecting the beginning of the market deterioration. The assets of the three plans had declined from $3,231-million as at July 1, 2007 to $3,004-million as at July 1, 2008. Ms Brown outlined the changes over the year. Contributions had been added amounting to $126.4-million. The plans' investments had, however, declined in value by 5.9%, net of fees and expenses. That compared with a positive return of 20.0% in 2006-07. Payments to pensioners had amounted to $136.4-million, an increase from $132.1-million the previous year. It was interesting to note that the payments of $136.4-million were not much greater than the year's contributions of $126.4-million. The pensions paid in the year were very nearly covered by current contributions. Fees and expenses amounted to 1.04% of assets in 2007-08, compared to 0.85% the previous year. The growth of fees was attributable to two factors. First, some fees were not assessed as a proportion of assets under management. As the total value of the assets had declined over the year, the proportional cost of their management had increased. Second, the University of Toronto

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

Asset Management Corporation (UTAM) had continued to move towards placing a greater proportion of assets into alternative investment categories, which were expected to provide higher returns over time but at a greater cost immediately in terms of management fees.

- **Market surpluses and deficits**. The surplus in the main registered plan had reached a high point in 2000, amounting to $579-million, but it had declined to a deficit beginning in 2003. That decline had represented a shift of $782-million in the position of the plan. The plan had returned to a surplus position of $184-million in 2007, before its decline to a deficit of $165-million in 2008. The OISE plan had been in a surplus position throughout the past ten years, but that surplus had declined to $1.7-million in 2008. It was proceeding to the point where it would again be necessary for the University to make employer contributions to that plan. The funds set aside to provide for the University's obligations under the S.R.A. had been sufficient to match and exceed the related liability since 2005. As at July 1, 2008, the excess amount was $34.4-million. Because the S.R.A. was an unregistered plan, any excess amount in the fund set aside for the S.R.A. could be used by the University to contribute to the registered plan, if contributions were required by the regulators.

- **Changes to the financial status of the main registered plan, 2002-08**. Ms Brown illustrated the changes to the financial status of the main registered plan for the six years between 2002 and 2008. Accrued liabilities had been $1,862.9-million as at July 1, 2002 and had increased by 56% to $2,889.6-million as at June 30, 2008. The interest on the liabilities in the going-concern valuation had been $905.7-million, which had been offset by the $989-million growth in the assets as the result of investment return. The $480.6-million of benefits earned by active members of the plan in the six years had been almost exactly offset by $503.91-million in contributions and transfers. One notable factor increasing the accrued liability had been the $99.3-million cost of benefit improvements. Over the period, the market value of the plan assets had increased by 46%, compared to the 56% increase in the accrued liability.

- **Sensitivity analysis: impact on the surplus / deficit of changing the discount rate on the plan liability and the assumed rate of return on pension fund investments**.
Ms Brown noted that over the past several years, the liabilities of the plans for valuation purposes had been discounted to their present value at a rate of 4% plus the rate of inflation (i.e. 4% real) per year. Similarly, the anticipated rate of future return on the investments of the plan had been assumed to be 4% per year after inflation. Looking at average returns over the years, the plan had met or exceeded the 4% real-rate assumption, and the administration had therefore felt quite comfortable with the assumption. For the main registered plan, Ms Brown noted that the deficit as at July 1, 2008 was $165-million. If it was assumed that the return on the pension fund and the discount rate on the liability was 3.75%, the deficit would grow to just under $260-million. In general, for each quarter percentage point reduction in the discount rate, the deficit would grow by

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

$95-million. If the University were to decide to invest the pension fund solely in safe government bonds, the likely rate of return would currently be around 2% per year after inflation. Discounting the liability at 2% would increase in the deficit to over $1-billion.

- **Sensitivity analysis: impact on pension plan contributions of changing the discount rate on the plan liability and the assumed rate of return on pension fund investments**. Ms Brown recalled that there were only two ways of funding a pension plan: contributions and investment returns. If the assumption concerning investment returns were to be reduced, it would be necessary for the plan to have larger contributions. For the main registered plan, the University's current service cost for 2008-09 had been $69-million. (That did not include employee contributions or the additional University contributions to deal with the plan deficit.) If the assumed return on investments and the discount rate were reduced to 3.75%, the current service cost would increase to over $74-million per year. If the assumed return were dropped to the 2% rate that would be appropriate if the plan were to use only government bond investments, the University's current service cost would increase to $129-million per year – a $60-million annual increase.

- **Determining an appropriate discount rate**. Ms Brown said that the sensitivity analyses concerning the outcome of different discount rates on the surplus/deficit and on the current service cost demonstrated the need for balance between reasonable and affordable contributions and a rate of investment return that was reasonably achievable within a risk tolerance the University was able to handle. The definition of a 10% risk tolerance over ten years could be viewed in the light of the current pension funding strategy, calling for the University to budget and set aside for pension purposes an amount of $27-million per year in addition to the required current service contributions. With the 4% discount rate, a 2007 study had indicated that there was a probability of just over one in three that the University would have to increase that $27-million amount by 2011. On an on-going basis, the additional amount of $27-million per year could cover about $263-million of pension deficit, amortized over fifteen years.

- **Effect of market turmoil beginning in late 2008**. Ms Brown reported that the value of the pension fund had declined by 9.8% from July 1 to September 30, 2008. Then, with the addition of the severe market decline in October, the decline from July 1 to October 31 had increased to 21.3%.

- **Solvency valuation**. Ms Brown noted that the plan had a solvency deficit of $217-million as at July 1, 2008. That deficit was an important one in that it could trigger the need for action to meet government requirements. Nonetheless, the University, in determining its course of action, sought to do so as much as possible on the basis of the long-term, going-concern valuation comparing the actuarial liabilities to the market valuation of the assets.

Ms Brown concluded that it was important to look at the funding of the pension plan with a longer term perspective. Markets went up and down. The recent decline had been a severe one,

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

but it had followed a gain of 20% in 2007-08. Absent pension plan changes, the University would not be required to file an actuarial valuation until that for July 1, 2010. The University would use the year and one-half to observe market developments and to re-examine its pension-contribution strategy and its investment policy for the pension fund. It was very fortunate that the University had filed an actuarial valuation annually until 2007 in spite of the fact that such a filing was required only every three years. It gave the University time to deal with any solvency deficit that might appear, as indeed a solvency deficit of $217-million had appeared as at July 1, 2008. The University's annual filings until 2007 had been intended to provide just such flexibility. In addition to the $27-million it set aside each year over and above its current service cost, the University also had access to the $34-million surplus in the funds set aside to match the liability in the S.R.A., which could be used if necessary to deal with any continuing deficit in the funding in the registered plans. It was, however, important to note that the amount of that surplus had also declined with the severe investment markets.

Discussion focused on the following matters.

(a) Determination of the discount rate. In response to a member's question, Mr. Shapira said that the anticipated rate of return on the pension fund was determined by examining the historical returns on each asset class and combining them to reflect a basic asset mix for the plan. The discount rate for the liabilities was simply a reflection of the anticipated rate of return on the assets. The member noted that in the United States, the average interest rate on government bonds had declined to about 3%, but yield spreads between government and corporate bonds had become very wide, with AA corporate bonds yielding over 7%. Many corporations discounted their liabilities at a rate equal to that paid on their own bonds, hence substantially reducing the valuation of the liabilities in their pension plans. Mr. Shapira acknowledged that the outcome of the wide rate spread and the use of the corporate bond rate was indeed a substantial reduction of the liability. Using the lower government bond rate was, however, the appropriate method for the University.

A member asked whether there were circumstances where there would be need to change the discount rate of 4% plus inflation. Could benefit increases, growth in the number of retirees, or an upturn in the rate of inflation bring about a tipping point where it would be necessary to change the assumption? Mr. Shapira thought that the 4% real rate was a reasonably sustainable one over the long term. The challenge was dealing with the volatility of returns in the short term, such as the situation of a 20% return in 2007 followed by a 6% loss the following year. If, however, experience in the longer term showed that the discount and return assumptions could not be achieved, then the sooner a change was made the better. In such a case, if the University were to wait too long to make a change, it would have a large population of retirees who would not provide higher contributions, and the burden would fall upon the next generation of active members of the plan. The problem with waiting too long would be one of inter-generational equity. While Mr. Shapira was comfortable with the 4% assumption at this time, there was some concern that it was becoming increasingly difficult to achieve that return. Therefore, he and the University were carefully considering the potential for returns from each asset class, and the

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

alternative of a 3.75% real return and discount rate. He noted that the consequences of the change would (as noted by Ms Brown) have a considerable effect on the University's budget in terms of pension plan contributions.

Mr. Shapira noted that the University enjoyed some greater insulation from short-term concerns because of the growth in the number of active, contributing members of the plan. That provided a greater inflow of contributions, which enabled the University to adopt a somewhat more aggressive investment policy in an effort to generate higher investment returns.

Mr. Shapira said that if it was necessary to reduce the discount rate and return assumption, as it might be, it would then be appropriate to negotiate how that burden would be shared by the University and active plan members. Because a reduction in the discount rate would cause an increase in the deficit to be amortized by the University, it would be unrealistic to expect the University to handle both that increased cost and also to handle on its own the increased current service cost.

(b) Possibility of change in the rules governing Ontario pension plans. In response to a member's question, Mr. Shapira said that he did anticipate some relief with respect to rules concerning the time allowed for elimination of plan deficits. The Government of Canada, which regulated only about 10% of pension plans, had provided some relief, but it had been made conditional on consent by two thirds of plan members or on the filing of a letter of credit that would enable the plan to deal appropriately with its deficit if other efforts failed. Those conditions were not easy ones.

(c) Possibility of immunization of the liabilities of the plans. A member asked whether, if a recovery in the value of the assets brought about a new surplus, the University would consider immunizing its liabilities under the plan, that is holding certain fixed income securities to specifically match and fund scheduled payments from the plan. Ms Riggall replied that she was sure that such a strategy would be considered, but she was not at all certain that it would be adopted. Mr. Shapira said that it would be necessary to designate fixed-income securities to deal both with the past-service and the on-going costs. However, if the plan's assets increased sufficiently, immunization would allow the University to lock in the gains on the assets and to take less risk in its investment policy. That would be particularly useful in a situation where the liability structure was increasing.

(d) Audited financial statements: external auditors' report. Ms Tory commented on the audited financial statements of the two registered plans. The most significant issue in the audit was the valuation of the plan assets, especially in the light of the recent economic difficulties. The auditors were both aware of those difficulties but also conscious that the value to be established was that as at June 30, 2008, before the major turmoil that had taken place in the fall. Ms Tory said that there had been no difficulty in auditing the value of the securities that were publicly traded. A substantial amount of time had, however, to be spent on the valuation of the alternative investments that did not trade. The values provided at the end of June were often those based on March data,

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

given the lag in asset valuation in the alternative categories such as private equity funds and hedge funds (and especially the funds of hedge funds). The auditors therefore sought to use data that became available after the June 30 valuation date to corroborate values as at June 30. No significant differences had been found in that work. The values of the investments at later dates might well, however, diverge substantially from the June 30 figures because of the exceptional developments in the markets.

(e) Auditing the valuation of alternative investments. The Chair asked about procedures for auditing the valuation of private-equity investments. Where the pension fund's investment formed only a small proportion of the total private-equity fund, would Ernst & Young perform an audit to determine the appropriateness of the fund's valuation of its probably widespread assets? Ms Tory replied that Ernst & Young did not audit private-market investments in that way. It used other bases for its audit examination. It compared June 30 valuation estimates to earlier valuations. It examined the adequacy of UTAM's due-diligence procedures both before and after decisions to invest to satisfy themselves that the funds were well managed and that valuations were appropriate. In October, Ernst & Young looked again at the valuations, comparing them with the most recent audited statements of the funds and making a judgement whether changes in the value since the audited statements were reasonable in the light of general market and other developments. Ernst & Young looked not only at the specific valuations but also at management's general record in providing valuations that were subsequently confirmed by the audited valuations. The approach was consistent with that used in previous years, except for the added steps necessitated by the unusual financial situation of the fall.

(f) Disclosure concerning the valuation of private investments. A member asked about disclosure of the basis of valuations of private investments. Was there likely to be more disclosure in the next year's statements? Ms Tory replied that there was substantial disclosure in the University's audited financial statements of the basis of valuation of private equity investments, in particular disclosure about reliance on third-party valuations. New rules requiring more extensive disclosure would not come into effect for universities until the 2010 financial statements. Management would be able to make choices about disclosure for the 2009 statements.

A member asked whether the issue of valuation of private-market and other alternative investments would come into play in connection with any decision to issue further debt. Ms Riggall said that the matter had not been considered. The primary obstacle to the issuance of more debt at this time was the University's borrowing policy, which limited external debt (now $556-million) to 40% of the University's net assets smoothed over the past five years. The sharp decline in the value of the endowment funds – the largest component of net assets – might well limit the extent of additional borrowing. (In response to a member's question, Ms Riggall said that if the University reached its borrowing limit, it would cease to issue further debt until borrowing reached the level of one third of net assets. There were no covenants on the existing debenture issues that would be affected.)

(g) Trustee and custodian fees. A member observed that there had been a substantial increase in the fees of the trustee and custodian of the assets from $786,000 the previous year to $933,000 in 2007-08, notwithstanding the absence of any increase in the value of the assets.

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

On the recommendation of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

(a) THAT the audited financial statements for the University of Toronto Pension Plan, June 30, 2008, be approved, and

(b) THAT the audited financial statements for the University of Toronto (OISE) Pension Plan, June 30, 2008, be approved.

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

4. Audit Committee Terms of Reference: Annual Review

The Chair noted that the Committee's Terms of Reference were placed on the agenda of its first meeting each year. There were no suggestions for revisions.

5. Calendar of Business, 2008-09

The Committee received for information its Calendar of Business for 2008-09, showing the items planned to come before the Committee in the coming year.

A member observed that the Committee was currently holding its first meeting of the academic year and was reviewing two reports – the financial reports on the endowment and on the pension plans – that were excellent reports but were seriously out of date. With the severe recent declines in the securities markets, the situations of the endowment and pension funds were very different from those described in the reports. The member suggested consideration of the possibility of a September meeting to deal with those important reports in a timely manner.

Ms Brown replied that the annual report on the endowment for the fiscal year ended April 30 was prepared primarily for the information of major donors to the endowment. The report was based on the information contained in the audited financial statements, which had been reviewed by the Committee and approved by the Governing Council. The report was posted on the web as soon as it was available in August. It was provided to the Business Board and the Audit Committee for information at their earliest meetings, and it had been received by the Business Board at its September meeting. The financial report on the pension plans, for the plan year ended June 30, had been completed only days before its mailing to the Committee. Because of the time required for the preparation of the actuarial report, it was not possible to produce the pension plan report any earlier in the year. In response to a question, Ms Tory noted that the length of time required for the actuarial report could be

5. Calendar of Business, 2008-09 (Cont'd)

attributed to the fact that a full valuation was performed each year. In the case of many pension-plan reports, the information provided was based not on a full valuation but rather on a roll-forward of financial information from the pervious year.

The member questioned the need for more than five months after the end of the plan year to prepare an actuarial valuation and she agreed with a suggestion that the actuary, who was not yet present,* be asked to comment on the question. In any event, it did not add value for governance to consider a report that contained information that was so clearly out of date. For the current year, the concern could be dealt with by an update on the value of the assets.

Ms Riggall stressed that financial management of the pension plans was a long-term matter; action could not and should not be taken on the basis of a single year's financial report. Rather the reports should provide overall guidance in making decisions.

The Chair noted that a basis for the discomfort was in part the fact that the Committee did not meet on a more regular basis such as quarterly. It met twice within a short period time – in May and June – but a great deal of time then passed before it met again. He suggested that attention be given to the matter of the Committee's schedule.

6. Internal Audit Department: Semi-Annual Report, October 31, 2008

Mr. Britt presented the Internal Audit Department's Semi-Annual Activity Report for the six months ended October 31, 2008. Among the highlights of the report were the following.

- **Productivity**. The Department had in the first six months of the year issued eleven final reports on reviews and two draft reports. A further thirty reviews were in progress, including twenty-one follow-up reviews. Auditing hours provided were in line with the plan for the year. The Department's complement was a bit low owing to two staff members' taking maternity leave and one leaving the Department. The Department was currently at full staff, although its complement was 7.65 full-time-equivalents rather than eight as the result of budgetary pressure. The allocation of hours among the various audit activities was reasonably consistent with that planned although there had been some deviation owing to the timing of assistance to the external auditors as well as staff vacations.

- **Special reviews**. Two special reviews had been undertaken during the year. One review, concerning a possible conflict of interest, was still underway. The other was an audit of a grant to the University provided by the European Commission. The review had been undertaken at the request of management because the grant did not provide sufficient funds to enable the engagement of an external auditor. The outcome of the audit had been the recovery of some funds.

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* This item was considered by the Committee before item 3 of this report, dealing with the Pension Plans. Items for Business Board approval traditionally appear as the first substantive items in these Committee reports.

6. Internal Audit Department: Semi-Annual Report, October 31, 2008 (Cont'd)

- **Departmental audits**. Mr. Britt noted that a ranking system for departmental audits had been in use. Rankings were noted as: (a) strong controls / low risk; (b) adequate controls / medium risk, or (c) needs improvement / high risk. He referred members to Schedule 1 of the Semi-Annual Report containing the outcomes of the seven completed reviews, showing adequate controls in six departments and one department where controls required improvement. Mr. Britt had concluded that overall there had been no unreasonable level of financial risk. While the Department's findings were of sufficient significance to require reporting some risks to the units, those risks were in all cases contained within the individual units, and in all cases the units' management had responded with plans for improvements to be made on a timely basis.

- **Administrative accountability reports** had been required from forty staff members of the units audited in the six months covered by the report. (That number was a low one because most of the units reviewed had been central administrative units.) Only one report had not been submitted, owing to an oversight.

Mr. Britt was pleased to report that the Department was currently on target to complete the audit plan for the 2008-09 year.

Among the matters that arose in discussion were the following.

(a) Follow-up reviews. In response to a question, Mr. Britt said that in any review where a departments' controls were identified as needing improvement, the Internal Audit Department sought to complete a follow-up review within six to nine months from the date of the issue of the original report.

(b) Need for improvement in an information technology department. In response to a member's question, Mr. Britt described problems found in an information-technology department where controls or procedures were deemed to require improvement. The internal auditors had found that the department's data backup and recovery processes were ineffective. The unit's backup tapes had not been tested and, in response to the internal auditor's request that the backup tapes be tested, they were found not to be functioning. The department had no formal disaster recovery / business resumption plan, although it was currently working to develop such a plan. The department also had no procedure to track patterns of problems that would enable it to identify systemic weaknesses. While those problems had not been expected in a specialist information-technology department, similar problems had been identified in two comparable units in the previous year. In response to the member's question, Mr. Britt said that the units involved were responsible for facilitating certain information-technology services, but they were not responsible for maintaining University data.

(c) Use of the three campuses for purposes of data backup and disaster recovery. In response to a question, Ms Riggall said that the Department of Administrative Management Systems backed up St. George Campus data at a site in the Faculty of Dentistry building on

6. Internal Audit Department: Semi-Annual Report, September 30, 2006 (Cont'd)

Edward Street, which was somewhat removed from the primary campus sites. She was unaware of the arrangements for data backup at the other campuses. The member noted that the University was fortunate to have three campuses to provide separated sites for data backup.

(d) Procurement problem. A member requested information concerning the failure of a student residence operation to comply with procurement procedures. Mr. Britt said that the residence had an on-going relationship with a cleaning company to supply services. The residence had simply renewed that contract annually, failing to complete appropriate tendering processes.

(e) Reviews of capital projects. In response to a member's question, Mr. Britt said that the external auditors were currently conducting a review of the operations of the Real Estate Operations Department with respect to its tendering and awarding of contracts for capital projects and its administration of those projects. The review was a regular one initiated in accordance with the internal auditors' risk-assessment process.

7. Endowment: Annual Financial Report for Year Ended April 30, 2008

Ms Brown said that the report was prepared based on financial data at the end of the fiscal year. The primary audience intended for the report was major donors. It also provided useful information for the Audit Committee and the Business Board, and it was placed on the web for any interested reader. The report was the University's third annual report on its endowment funds.

Ms Brown provided information to bring the report up to date in the light of developments in the financial markets after April 30. As at April 30, 2008, the value of the endowment funds had been approximately $1.75-billion, reflecting a decline for the year of 2%. From May 1 to October 31, 2008, the market turmoil had led to a further decline of 22.9%, amounting to $402.8-million. The value of the endowment funds as at October 31, 2008 had been $1.43-billion. That amount reflected both the decline in the value of the endowment fund's investments and additions of $80.6-million from donations and gifts. It did not include any accrual for a payout.

Ms Riggall added that as at April 30, 2008, the endowment funds had included a reserve or cushion of over $287-million, representing previous investment gains above the amounts allocated for spending and the amounts required to increase the principal of the endowments to compensate for the effects of inflation. There had been pressure at the time of the 2007-08 payout to increase it more than the actual increase, which was an increase of 2% over the previous year's to compensate for inflation and an additional 5% to maintain the payout at 3.5% of the opening balance of the endowment, that is at the same percent as the previous year. The administration had, however, rejected the pressure for a further increase.

Discussion focused on the following topics.

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

(a) Endowment payout for 2009-10. In response to questions, Ms Riggall and Ms Brown said that in the absence of an improvement in the financial markets, the University would probably not make a payout for 2009-10. A final decision would not be made until late in the year when a reasonable estimate of the investment return on the endowment could be made. The University hoped that the return would improve to at least a loss of 10% or less. If it did so, the University would be able to make a payout while still maintaining the value of the endowment against the effect of inflation.

Two members asked about the consequences of omitting the payout for the year. Would the divisions be able to balance their books? Ms Riggall and Ms Brown replied that the divisions were currently working on precisely that question. Certain costs, usually funded by the endowment payout, could not be avoided. The University had to pay the salaries of the incumbents of endowed chairs and professorships, and it wished to provide need-based student aid. The divisions were therefore seeking alternative ways of meeting those costs. They could consider three possible means of doing so. First, each endowment fund had an expendable account associated with it, containing the accumulated payout made over time but not spent to date to meet the purpose of the endowment. There were significant positive balances in some of those accounts. Second, the academic divisions often had other expendable trust funds arising from donations and grants to support the unit. In some cases, the use of those funds was limited by various terms and conditions; in other cases, the terms and conditions were such that the funds were available more broadly to the academic unit. Again, in some cases, the balances in the expendable trust funds were significant. Finally, many divisions had carry-forwards of unspent operating funds appropriated in the previous year's budget. The sum of the balances in the three types of accounts could be brought to bear by the divisions to deal with a part of their commitments normally handled by the endowment payout. Ms Riggall stressed that no final decision had yet been made concerning the endowment payout. Divisions had, however, been advised to consider their course of action in the absence of a payout so that they would seek to preserve the monies available to them in the types of accounts described by Ms Brown for purposes that would normally be funded by the endowment payout.

(b) University support for endowment investment objective and risk tolerance. A member noted that the endowment fund was a long-term fund. For that reason, it was probably appropriate that the investment policy accept somewhat more short-term risk in an effort to achieve a higher return in the long term. However, in the previous period of market retrenchment, early in the 2000s, there had been some consternation in the University when there had been a negative return on investment and there had been some expression of the view that the University should accept less risk in the investment of its endowment funds. Were members of the University generally aware of the extent of the losses in the endowment fund? Was there once again support being expressed for a more conservative investment policy? Were the administration and UTAM ready to respond to the expression of such views?

Ms Riggall said that there had been communications to members of the University to make them well aware of the general difficulties being faced by the University's endowment funds as well as the markets in general. The unit value of the endowment funds was published monthly for those

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

who wished that information. UTAM's strategy was clear and it took the general view that the University's return target was a difficult but achievable one over the ten-year time horizon. The losses incurred by the endowment fund were not the outcome of any failure by UTAM but reflected the general conditions in the securities markets. In response to a question, Ms Riggall said that the decline in the value of the University's endowment funds was similar to that experienced by other universities in Canada and the United States. The decline was a painful one, but at this point the consequences were manageable. There was at this point no need for a drastic program of staff reductions. That need would develop only if the decline in the securities markets continued over a period of years. The Chair noted that the University relied on the income from its endowment for less than 4% of its operating income.

(c) Risk tolerance of the endowment and pension funds. In response to a question, Ms Brown said that the formal risk tolerance of the endowment and pension funds was the same: an average maximum standard deviation of 10% over ten years. The consequences of that risk tolerance were, however, looked at in different ways. For the endowment funds, the question asked was how frequently would the University have to provide $10-million or more in operating funding to replace the planned endowment payout. The University expected that, with its stated risk tolerance, such an addition to the payout would be required in one year out of nine. A very large extra sum would be required for an endowment payout for the 2008-09 year, notwithstanding the fact that there had been $287-million in the fund above and beyond the previous payouts and the amount required to offset the effect of inflation. For the pension fund, the University budgeted $27-million per year over and above the employer current-service cost for a reserve fund to provide any necessary additional funding for the three pension plans. With its stated risk tolerance, there was just over a one-third chance that by 2011, the University would have to increase that $27-million amount.

8. Administrative Accountability Reports: Annual Report on the Program

Mr. Piché presented the annual report on the program of administrative accountability reports. The Office of the Controller had examined all of the accountability reports submitted by the Vice-Presidential group and had found no negative responses. It had also examined all of the reports from the heads of academic and service divisions reporting to the Vice-President and Provost. There had been only five negative responses. Copies of the President's administrative accountability report had been distributed to members of the Committee.

The Chair asked whether the five negative responses were being followed up. Mr. Piché replied that they were. In most cases, the Deans had delegated to their Chief Administrative Officer the responsibility for reviewing system-generated financial reports, whereas they were expected to review those reports themselves. Ms Brown and Mr. Piché said that the expectation that the Deans personally review those reports might well now be out of date for many divisions. A number of divisions had appointed very senior people to the position of Chief Administrative Officer. Those officers did not themselves process financial transactions and they could therefore review the transactions processed by their staff members without violation of the principle of segregation of duties.

9. External Auditors: Engagement Letter, Audit Plans, Report on Accounting Developments, Fee Proposal and Report on Non-Audit Assignments and Fees

Ms Tory introduced the engagement letter, external audit plan and audit fee information. She said that the approach to the audit would be consistent with that of the previous year. She anticipated that, as with the audit of the financial statements of the pension plan, there would be some additional attention given to reviewing the valuation of alternative investments. The level of materiality would remain unchanged from the previous year ($15-million or approximately 0.75% of projected total revenues). The external auditors would continue to work with the University's Internal Audit Department, which would complete certain work to assist with the main audit and would undertake certain special reports. Ms Tory anticipated that Ernst and Young would be able to deploy the staff members listed in the report to work on the audit, including several who had worked on the audit for the 2008 statements. With respect to the audit fees, there would be only the customary increase to compensate for inflation. The auditors had begun to discuss various issues with management. She praised Ms Brown, Mr. Piché and their team, who were highly attuned to current issues and who had provided clear analyses of their impact. There would be choices for management to make concerning the presentation of certain items in the financial statements as new rules were being introduced pursuant to the application of International Financial Reporting Standards (I.F.R.S.) in Canada. Ms Tory did not anticipate that the impact of those changes would be a large one for the University for the 2009 statements. Application of new rules on disclosures concerning financial instruments had been delayed for one year for not-for-profit organizations. The Canadian Institute of Chartered Accountants (C.I.C.A.) was still working on appropriate rules for not-for-profit companies for disclosures concerning financial instruments. It was unclear whether not-for-profits would be required to adhere to the same rules as public companies or whether they might be permitted to adopt the disclosure rules for private companies. While such uncertainty remained, it was sensible to delay the application of rules to the not-for-profits to avoid their having to develop one set of disclosures for one year only to be followed by another set in the next year.

A member observed that the University was not, like many other not-for-profits, a small organization. It had endowment funds valued at $1.75-billion as at the end of the last fiscal year. In such circumstances, it appeared that it would be inappropriate for the University to have a reduced level of disclosure and transparency. It would also not be helpful to the University's efforts to raise further funds. The member asked whether the question had been discussed with other large universities. Mr. Piché replied that there had indeed been discussions across Canada. Ms Brown and he were scheduled to attend a session on the topic sponsored by the C.I.C.A. He agreed that the University was a very large organization relative to many other not-for-profits, and it would be important to ensure that the new accounting rules met its needs. No decisions had been taken to date. Ms Tory added that the I.F.R.S. rules had not been written with not-for-profit organizations in mind, and they did not address a number of issues that were unique to such organizations. In the absence of further rules, the University would have to go back to the basic principles of the I.F.R.S to develop ways of accounting for such things as government grants and donations.

9. External Auditors: Engagement Letter, Audit Plans, Report on Accounting Developments, Fee Proposal and Report on Non-Audit Assignments and Fees (Cont'd)

The member asked how universities in other jurisdictions handled their accounting. Mr. Piché replied that he was aware of the rules used by Australian universities. Although Australia operated under the I.F.R.S., the universities stated specifically that their accounting was not covered by the I.F.R.S. rules. Rather, they had adopted their own rules.

Ms Tory noted that the current C.I.C.A Handbook had a separate section specifically for not-for-profits. However, there would not be a specific section for non-for-profits under the I.F.R.S. rules. It appeared more likely that not-for-profits would be required to use the rules for private companies, with the addition of any further appropriate rules. The I.F.R.S. standards for public companies would, in Ms Tory's opinion, not be helpful for not-for-profit institutions. The current comprehensive notes in financial instruments would become even more detailed, and it would be very difficult for most readers to understand the risk and reward arising from the disclosures.

A member requested clarification of the accounting issue (shown on page 8 of the Audit Planning document) concerning "transactions where the University is the principal rather than an agent" which would "need to be reported gross in the financial statements." Ms Tory said that the matter referred to situations, primarily in the Faculty of Medicine, where the University paid an employee's salary but recovered it from one of the affiliated teaching hospitals or some other institution. It was possible in such situations to think of the University merely as a facilitator or conduit and not to record the gross amount of the salary and the recovery. However, the University would have the contractual obligations associated with the relationship with the employee, and it would, according to the new accounting standard, be required to report the gross amount of the expense and the recovery. The matter was a significant one in that the amount of the expense and recovery was approximately $20-million.

On motion duly made, seconded and carried,

> The Audit Committee ACCEPTED the external auditors' engagement letter and audit plan for the year ended April 30, 2009, as outlined in the report from Ernst & Young dated November 10, 2008.

10. Enrolment Report to the Ministry of Training, Colleges and Universities, 2007-08

Ms Brown said that the audited Enrolment Report was prepared each year for the Ministry of Training, Colleges and Universities. The report confirmed the number of students in various categories of programs, which was the basis of the University's claim for operating grants. The report also showed the total of the "formula fees" for the University's students. The enrolment was used to calculate a gross Provincial grant entitlement, and the formula fee – a very approximate proxy for the fees paid by the students – was deducted from that amount to determine the actual operating grant provided by the Province. A member noted that the University's enrolment of over 74,000 full-time-equivalent students represented a very large increase in recent years.

11. Dates of Next Meetings

The Chair reminded members that they were asked to set aside time for a meeting on **Thursday, March 5, 2009 at 4:00 p.m.** That time would be used only if business arose that would require the Committee's attention before the May meeting. The next regular meeting was scheduled for **Tuesday, May 19, 2009 at 4:00 p.m.** That meeting would consider any changes to the format of the audited financial statements, the draft notes to the statements, the annual risk assessment profile, and the annual report on insurance and risk management.

The Chair also reminded members of the "off line" meeting of the Business Board planned for Tuesday, January 6, 2009 at 4:00 p.m. in the Council Chamber. Members of the Audit Committee were cordially invited to attend that meeting. The "off line" session would consider the impact on the University of the current problems in the financial markets. It was intended that the private meeting would provide the opportunity for broad discussion and interchange of advice.

Ms Riggall noted that the annual report on the pension plans would proceed to the Business Board at its meeting on Monday, December 15 at 5:00 p.m. in the Council Chamber. Members of the Audit Committee would be very welcome to attend that meeting.

12. Ontario University Audit Committees: Meeting of Chairs and Members

Mr. Lindblad reported on the recent meeting of Chairs and members of Ontario university audit committees, held at York University, which he and Mr. Britt had attended. He had prepared notes on the outcome of that meeting, which had been distributed to members. He had also provided the Chair with copies of material distributed at the meeting, which the Chair would be pleased to copy for any Committee member.

One of the things that stood out for Mr. Lindblad was the frequency of meetings of the audit committees at the other universities. They met an average of five to six times per year and held special meetings quickly when some special situation developed. When Mr. Lindblad had begun to attend these province-wide meetings, he noted that the University of Toronto had been regarded as very much a leader in developing the work of university audit committees. More recently, however, the other committees had clearly caught up and were innovating in a number of areas. In some cases the mandates of the audit committee had been broadened to include such matters as finance or even human resources. The audit committees were also taking a broad responsibility for risk assessment, including risks beyond financial ones, for example reputational risk. There also appeared to be a growing emphasis on internal audit, with the committees clearly seeing greater value in the area. Some committees had concluded that the work of the internal auditors had prevented serious problems, the cost of which would be significantly greater than the cost of internal audit departments.

Among the matters that arose in discussion were the following.

(a) Provincial audits. Mr. Lindblad noted that the Province's Auditor General had attended the meeting and made a presentation. Ms Riggall said that the audits of universities would deal

12. Ontario University Audit Committees: Meeting of Chairs and Members (Cont'd)

with specific matters. Three universities would be selected for audit and the results distributed to all universities. Mr. Britt said that because of resource limitations, he did not expect that there would be another audit of the universities until 2010. Neither the universities nor the specific subject of the next audit had been selected.

(b) Whistle blowing. Mr. Lindblad noted that a great deal of emphasis had been placed on the means for "whistle blowing." However, many of the problems reported had dealt not with financial fraud or error but with employee concerns about their own treatment. Ms Riggall noted that employees at the University of Toronto could report and seek redress for non-financial concerns to a number of offices: the Ombudsperson's Office, the Sexual Harassment Office, the Status of Women Office, and the Race Relations and Anti-Racism Initiatives Office, among others.

(c) Broader functions for audit committees. In response to the report about the broadening of functions of audit committees elsewhere, a member expressed concern about an absence of separation of functions of the audit committee and responsibilities for other matters such as finance. Ms Tory replied that some institutions lacked a sufficient number of financially literate trustees to serve on several committees. The co-opting of financially literate members was not always a good solution as those individuals were not engaged in, and therefore not knowledgeable about, the overall issues facing the institution.

(d) Comparison with practices in the U.S. A member suggested that it might be useful for the Committee, and indeed for the next meeting of Chairs of Ontario university audit committees, to examine the practices of audit committees in the United States and to compare the functioning of their audit committees to the best practices in the U.S.

(e) Risk Management function. A member suggested that it was appropriate for the Audit Committee to lead governance in the area of risk assessment and risk management. Ms Riggall noted that, on the suggestion of the Committee, the administration was working to establish a practice of risk management in each of the divisions. Divisions and departments would be given a questionnaire dealing with risk assessment, and they would be asked to undertake a risk assessment of their operations. They would be asked if they were comfortable with the level of risk within their unit. If they were not comfortable with the outcome of the internal risk assessment, they would be asked to seek assistance for the next most senior level in the organization. The internal auditors would assess the completion of this risk assessment as part of their program of departmental audits.

The member suggested that each Governing Council committee be asked to undertake an assessment of risk within its area of jurisdiction and to submit the assessment, with commentary, to the Audit Committee. That would focus the attention of the committee chairs on the matter of risk assessment and risk management.

12. Ontario University Audit Committees: Meeting of Chairs and Members (Cont'd)

(f) Frequency of meetings. Mr. Lindblad stressed the emphasis placed by other committees on their frequency of meetings, in particular on their meeting promptly to deal with any problems that arose within their terms of reference. The Chair noted that the University of Toronto Committee's functions were limited by the existence of the Business Board, which had responsibility for such functions as finance, investments and human resources. This committee met relatively infrequently, in part, because the University did not produce quarterly financial statements for committee review. A member reiterated her suggestion of an earlier meeting to deal with the pension plan's financial statements. Ms Brown again stressed that it would not be possible to produce the pension plan statements earlier, given that the actuaries required data from the July payroll to begin work on their valuation and that other work in turn depended on the actuarial valuation.

The Chair said that he would discuss with the Vice-Chair the responsibilities of the committee and would consider the potential value of more regular meetings. Mr. Charpentier said that such consideration would be timely in the light of the work currently being carried out by the Task Force of Governance, which was considering such matters as the delegation of authority and the distribution of responsibilities within governance. The Task Force would no doubt be grateful to receive advice from the Chair and Vice-Chair on the functions of the Audit Committee.

The meeting adjourned at 5:50 p.m.

Secretary   Chair

February 6, 2009

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