UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 91 OF THE AUDIT COMMITTEE

June 17, 2009

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 17, 2009 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy (Vice-Chair)
Professor Ramy Elitzur

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:

Ms Dominique Barker
Mr. Paul E. Lindblad
Mr. Joseph Mapa

In Attendance:

Mr. Pierre G. Piché, Controller and Director of Financial Services*
Ms Mae-Yu Tan, Assistant Secretary of the Governing Council*
Ms Martha J. Tory, Ernst & Young***
Mr. Weeman Wong, Ernst & Young***

* Absented themselves for consideration of items 2(c) and 10.
** Absented himself for consideration of item 2(c).
*** Absented themselves for consideration of items 3 and 10.

ITEMS 2 AND 3 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 90 (May 19, 2009) was approved.

2. Audited Financial Statements for the Year Ended April 30, 2009

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 – were for information.

Ms Brown thanked Mr. Piché and his staff, Ms Tory and the external auditors' staff, and Mr. Britt and the internal audit staff for the enormous amount of work they had completed in a short period of time to prepare the Financial Report and to have it before the Audit Committee so soon after the end of the fiscal year. That achievement had required a great deal of work in the evenings and on weekends to meet very tight deadlines.

(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 at the affiliated hospitals.

- **Significant accounting concepts**. 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 on 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.

- **Significant accounting concepts: internal accounting**. 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 research grants; and (d) the capital fund for capital projects, except those for the ancillary operations. That fund accounting was not included in the audited financial statements, but it was presented in the second half of the Financial Report.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

- **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.

  A second example: an increase in donations would increase revenue for those donations that were expendable. Donations to the endowment would be recorded as an increase in the endowed funds and in assets, without flowing through the statement of operations. Third and similarly, investment earnings on expendable funds or internally designated endowment funds would be recorded as revenue, but investment earnings on externally designated endowed funds would be recorded directly as an increase in the endowed funds, assets and net assets, again without flowing through the statement of operations.

- **Net assets: general**. Looking at a graph displaying assets, liabilities and net assets over the past decade, net assets had increased over the period 2000-08, but the amount had then declined in 2008-09. The largest component of the University's net assets – accounting for 80% of the amounts - was the endowment, and the 2008-09 decline in net assets was the outcome mostly of the reduction in the value of the endowment.

- **Assets**. The decline in the value of the endowment was the result of an investment loss of about 31%, amounting to $545-million. That was partially offset by externally restricted donations and grants to the endowed funds amounting to $76-million. The value of the endowed funds had declined from $1.755-billion at the end of the 2007-08 year to $1.286-billion at the end of the 2008-09 year. Internally restricted assets had also declined by about $100-million. The primary element in that decline was the reduction in the value of the funds set aside by the University with respect to its obligations under the Supplemental Retirement Arrangement. Those funds, invested in the Long-Term Capital Appreciation Pool (L.T.CAP), had also incurred an investment loss. The investment in capital assets had remained stable. It represented the amount of University money spent on capital assets, and it would be amortized over future years, reflecting the depreciation of those assets.

- **Liabilities**. Liabilities other than deferred contributions had increased from $1.067-billion to $1.133-billion over the year, primarily as a result of an increase in employee future benefit obligations.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

- **Net assets** had been $2.174 billion as at April 30, 2008 and had declined by $557-million to $1.617-billion as at April 30, 2009. In addition to the decline in the value of the externally restricted endowments, there had been a net loss on the year's operations of $169.2-million, primarily as a result of investment losses of $83.3-million on internally restricted endowments and $63.4-million on other funds invested in the L.T.CAP.

- **Revenues**. Revenues of nearly $1.9-billion were fairly consistent with those of the previous year.

- **Net loss**. The net loss on the year of $169.2-million was mostly the outcome of the investment loss of $146.7-million on internally restricted funds. As noted above, that included the $83.3-million loss on the internally restricted endowment funds and the $63.4-million loss on other internally restricted funds in the L.T.CAP, including the funds set aside for the Supplemental Retirement Arrangement. Apart from those investment losses, the University was operating essentially on a break-even basis. Government grants had been stable at $646-million. The $7-million year-over-year increase had been the result of a small increase in enrolment of both undergraduate and graduate students. Student fee revenue (both tuition fees and other fees) had increased from $584-million to $636-million, the outcome of both the small increase in enrolment and the increase in the amount of fees. (A member observed that revenue from fees had come almost to equal the revenue from government grants.) Revenue from restricted grants and contracts, primarily for research, had increased significantly from $363-million to $435-million, reflecting the amount of funded research completed. (The revenue from this source was recorded as the research projects were completed.) Expendable donations had increased from $56-million to $82-million.

- **Revenue: Government and other restricted grants and contracts**. The University had received research grants amounting to nearly $400-million in 2008-09, an amount that had very nearly doubled over the decade, reflecting the success of the University's faculty in winning competitions for research funding. Grants for capital infrastructure and other purposes had increased from $73.1-million in 2007-08 to 130.7-million in 2008-09. The increase was the outcome of grants of $25-million for the School of Global Affairs and $27.8-million for the Martin Prosperity Institute and the MaRS Centre. Of the money received from government and other grants and contracts in 2008-09, $434.9-million was reported as revenue and $95.2-million was deferred on the balance sheet. A member asked about the decline in research grants from $423-million in 2006-07 to $372.6-million in 2007-08. Mr. Piché said that the decline was the result of the non-renewal of certain research grants by the three federal research granting agencies.

- **Endowed donations and grants and total donations**. Total donations in 2008-09 had increased to $131.5-million, a substantial increase from the $92.6-million total in the

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

previous year. Donations to the endowment had increased to $49.4-million and grants for the endowment had increased to $27.0-million. Those amounts did not include donations and grants to the federated universities and also did not include pledges that had not yet been fulfilled. Total pledges for the year to the University and its federated universities and other affiliated institutions had declined substantially from $183.0-million to $106.3-million.

A member asked about the reason for the decline in the amounts pledged: did the decline reflect the crisis in the financial markets or did it reflect concerns about the extent of investment losses incurred by the University's endowment funds? Ms Riggall said that she thought that the decline was largely the result of the current financial crisis. Ms Brown added that the University had only anecdotal evidence at this time. However, some donors to the endowment had been in touch with the University to make supplemental donations to replace the endowment payouts that had not been made. Remarkably few donors had expressed concern about the investment performance on the endowment funds. Many donors had themselves experienced similar or even greater losses. Apart from that anecdotal evidence, the University would have to wait the turnaround in the markets to make a judgement of the effect of the past year on the level of gifts and pledges.
Ms Riggall reported that the Vice-President, Advancement had reported a recent increase in significant donations for the first time in some months, and he was cautiously optimistic about fundraising going forward.

- **Endowments**. As noted above, the total value of the University's endowments had declined from $1.754-billion as at April 30, 2008 to $1.286.3-billion as at April 30, 2009, the result of poor market performance, offset by the receipt of grants and donations designated for endowed funds. The largest portion of the endowment, amounting to $543.9-million, was in funds to support student aid. The next largest element was the $395.5-million in funds to support endowed chairs and professorships. Other endowed funds supported academic and research programs. As at April 30, 2008, the endowment had built into it an amount of $256.6-million above the book value of the endowed funds to protect the funds against the effects of inflation and a further $287.1-million to protect the funds against the effect of a possible decline in the markets. The market setback during the year, plus the effects of the year's inflation were, however, of such magnitude that the decline in the market value of the endowment funds had eliminated both the inflation protection and the additional cushion and had eaten into the book value of the endowment. The market value was now slightly less than the book value, adjusted for inflation, notwithstanding the absence of a payout for the year.

- **Expenses**. The University's expenses had increased at a steady pace over the past decade, including the largest component of expense, which was salaries and benefits. "Other" expenses had increased in 2008-09 as the result of the University's receipt of valuable collections of art and media works, which are expensed in the year received and totaled

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

about $30-million. Spending on utilities had declined slightly. Spending on scholarships, fellowships and bursaries had continued its steady increase.

Salary and benefit expense had increased from $1.127-billion to $1.218-billion. There had been a significant increase in benefits expense from $207.5-million to 240.4-million, caused primarily by an increase in pension expense. As a result of the severe market decline, the deficit in the pension fund, as recorded in the financial statements, had increased from $337.5-million to $784-million. Continued deficits had caused an increase in pension expense for the year from $67.7-million to $94.2-million. Unless the investment markets turned around, there would continue to be increased pension benefit expenses to be recorded on the financial statements in future years.

Spending on salaries had also increased from $919.9-million to $977.9-million, reflecting the increase in the size of the faculty and staff required to deal with the increase in enrolment and reflecting also the effect of the salary increases during the year, as provided in various collective agreements.

- **Capital program**. Capital spending of $197.8-million included spending on equipment, construction, and land purchases. That element of expense had remained stable at about $200-million per year for the past four years.

- **Borrowing**. The University's maximum external borrowing capacity, as defined by policy, was 40% of the value of net assets, averaged over five years. As at April 30, 2009, that capacity was $758.4-million. Total external borrowing as at April 30, 2009 was $554.0-million, which was 34.3% of the 2009 net assets and 29% of the net assets averaged over five years – well under the policy limit. The increase in borrowing as a proportion of net assets between 2008 (25.6%) and 2009 (34.3%) reflected the decline in the value of the University's net assets arising from the decline in the value of the endowment funds.

  In response to a member's question about the historical data, Mr. Piché said that the increase in external borrowing from $216.7-million (17.1% of net assets) as at April 30, 2003 to $415.1-million (27.9% of net assets) as at April 30, 2004 reflected the issue of the series "B" debenture in the amount of $200-million on December 15, 2003.

- **Financial results compared to forecast**. Mr. Piché compared the year's financial results for the operating fund to the forecast that had been presented to the Business Board on February 11, 2009. That forecast had projected a $16.3-million growth in the operating fund deficit for the year. The actual growth in the operating fund deficit had been
  $6-million. The difference had arisen from grants for operations and research that had exceeded projections.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

The forecast of net assets had been based on a range of investment outcomes for the University's endowed funds. The most pessimistic outcome had been a loss of 30% of the value of the endowment funds. On that basis, the forecast of net assets had been \$1.612-billion. The actual net assets as at April 30, 2009 had been \$1.617-billion – very close to the forecast.

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

(i) Accounting for donations. In response to a question, Mr. Piché said that externally restricted expendable donations were recorded as cash when received and were also recorded on the other side of the balance sheet as deferred contributions until the amounts were spent, when both the assets and the liability were reduced. The monies were held in the Expendable Funds Investment Pool (EFIP) and invested, mostly in money-market securities and short-term bonds, by the University of Toronto Asset Management Corporation (UTAM) until spent. Externally restricted endowed donations were recorded directly as an increase in the endowment and were added to the Long-Term Capital Appreciation Pool (L.T.CAP), which also was invested by UTAM.

(ii) Risk of cash-flow problems. A member asked whether there was any significant risk that the financial results could lead to cash-flow problems for the University in the coming year. He referred to Statement 4, the Statement of Cash Flows, which showed that cash and equivalents as at April 30, 2009 had declined to \$66.8-million from \$138.8-million one year earlier. Ms Brown replied that she saw no cash-flow risk. She noted that all of the University's monies were included in one of two funds: the L.T.CAP, which included the endowment funds and the funds set aside for purposes of the Supplemental Retirement Arrangement, and the EFIP, which contained all of the University's other cash. Every dollar in the EFIP was attributable to a specific division or purpose: a division's operating cash, a research grant, a trust fund, the unspent portion of cash for a capital project, and so on. However, the EFIP was a very large fund. The balance in the EFIP ranged between \$400-million and \$800-million, depending on the time of year. Unspent money flowed forward from year to year. Its balance had not declined below \$400-million, and its upper limit had grown from year to year. The University completed extensive cash forecasting, seeking to predict inflows and outflows for a substantial time – as long as years - into the future. The inflows were reasonably predictable, with the exception of government grants made at the end of the government's fiscal year, and the outflows were very predictable.

The member noted that the Cash-Flow Statement reported cash and cash equivalents of only \$66.8-million at the fiscal year-end, following a reduction in cash and equivalents of \$72-million. How, then, could the balance in the EFIP be over \$400-million? And how could the University survive another year of comparable cash decline, which would reduce its cash balance below zero? Ms Brown referred to note 5 to the financial statements, which dealt with Investments. The second table in the note provided the breakdown of the assets in the EFIP,

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

which were valued at $772.7 million as at April 30, 2009. That included substantial sums in not only cash but also money-market funds, short-term notes and treasury bills, and short-term government and corporate bonds. Mr. Piché added that the $66.8-million in the cash-flow statement included only operating cash on deposit.

Ms Brown also referred to note 14, which dealt with internally restricted net assets. They included divisional reserves carried forward of $241.3-million and departmental trust funds of $67.7-million. Negative amounts for pensions and other employee future benefits were non-cash items. Ms Brown noted that the amounts used in the reserving mechanisms of the divisions and departments were carefully monitored.

A member noted that the University had issued $554-million of very long-term debt to finance capital projects. On the other hand, the University did have a great deal of cash on hand, with the balance sheet showing not only $66.8-million in cash and cash equivalents but also $756.4-million of short-term investments in EFIP and L.T.CAP. His concern was the likelihood of a negative spread: the University was probably earning less on its cash equivalents and its short-term investments than it was paying in interest on the debentures. Ms Brown agreed that there was currently a negative spread; nonetheless, the interest rate of the University's debentures was highly competitive.

(iii) Employee benefit plans: discount rate for the accrued benefit obligation. Referring to note 4 on employee benefit plans, a member expressed concern that the discount rate used to determine the accrued benefit obligation for pension and other benefit plan obligations had been increased from 6.0% to 7.75% although interest rates had declined over the year. Mr. Piché replied that the University was required for accounting purposes to use the 25 – 30 year corporate bond rate in order to link the determination of the liability more closely to the valuation of the plan assets. Ms Tory confirmed that the Canadian Institute of Chartered Accountants' *Handbook* required the use of the high-quality long-term corporate bond rate in effect at the time. It was unusual that the corporate bond rate had increased at a time when government bond rates had declined, and it was also unusual that the spread between the two rates was so large. The increased discount rate did, however, reduce the liability and cushion the impact of the decline in the corresponding assets. Ms Brown added that for funding purposes, the actuarial valuation also used a long-term rate but one based on multi-year thinking rather than the rate in effect at a particular time. The member noted that the use of the long-term corporate bond rate was not consistent with the International Financial Reporting Standards, which were soon to be adopted for use by public companies in Canada. Moreover, the discount rate was simply not realistic.
Ms Tory said that the rate used by the University adhered to the current Canadian standard: the current long-term rate for high quality corporate bonds having a duration that was consistent with the pension plan's liabilities. The auditors' specialist in accounting for benefit plans had reviewed the matter and had consulted with the plans' actuaries to ensure that they were comfortable with the rate used for financial reporting, given the rules currently in effect.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(a) Highlights of the Financial Statements (Cont'd)

(iv) International Financial Reporting Standards. A member requested comment on progress towards the formulation of appropriate accounting principles to be adopted upon the introduction into Canada of the International Financial Reporting Standards (I.F.R.S.). Mr. Piché replied that the matter had not yet been resolved. He thanked Ms Kennedy for her assistance in drafting the University's response to the Canadian Institute of Chartered Accountants on the matter.

Ms Tory reported that it appeared most likely that Canadian universities and other not-for-profits would be permitted to adopt the accounting rules for private, for-profit companies as modified by the Handbook's 4400 Series Rules. Those modifications would be very important to not-for-profits, particularly those with endowment funds, because of the rules for valuing investments. I.F.R.S. required the valuation of equities at their market value and fixed-income investments at their cost. Because such investments provided so important a part of the income of many not-for-profits, they would find it very difficult to make their financial outcomes clear with a mixed model. Ms Brown noted that the Canadian Association of University Business Officers supported the outcome described by Ms Tory. There was, however, some concern on the part of universities in western Canada, where financial statements were consolidated into those of the provincial governments. Ms Tory noted that universities and other not-for-profits whose financial statements were consolidated into those of governments would probably have the choice of using I.F.R.S., its Private Enterprise rules as modified for not-for-profits, or other rules promulgated by the Public Sector Accounting Board (PSAB).

(b) External Auditors' Report on Audit Results

Ms Tory presented the external auditors' "Audit Results" report. She recalled that the auditors had presented their audit plan to the Committee in the fall, and they had completed their audit according to that plan. Any items of audit significance that had arisen during the course of the audit had been discussed with management and were included in the written report. As always, the auditors had received excellent cooperation from management, who had completed the financial statements and the other aspects of the Financial Report extraordinarily quickly after the year end.

Ms Tory outlined the items of audit significance that had been discussed with management.

- **Year-end operating grants**. There had been need to discuss accounting for operating grants, arising from differences in the timing of grant payments because of differences in the fiscal year-end of the Government of Ontario and the University. Those changes had created some anomalies in accounting for the grants, with some accounted for on a cash basis and some on an accrual basis, creating a deferral at the University's year end. The auditors and management had come to a common understanding on the most appropriate way of handling the accounting.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(b) External Auditors' Report on Audit Results (Cont'd)

- **Year-end special grants**. Second, there had been discussion concerning the recognition of specialized grant revenue for 2007-08. That revenue would have been recorded differently had full information about the grants been available to the Financial Services Department at an earlier date. To have a record of the matter, the amounts had been recorded by the auditors in their 2007-08 summary of audit differences. In response to a member's question, Ms Tory said that the auditors were fully satisfied that the Financial Services Department was doing everything possible to seek the information needed to account for grants properly. With respect to grants made to divisions or departments, the University had amended its rules to require divisions and departments to provide an immediate report of the award of grants for amounts of $1-million or more. (Payment of such grants – usually research grants – was made through the Research Accounting department.) With respect to grants made by the Government to the University as a whole, year-end exigencies sometimes caused a situation where the purpose of the grants was not wholly clear.

  A member asked whether the Financial Services Department's monitoring of cash flow would reveal grants made to divisions or departments. Mr. Piché replied in the affirmative; such monitoring, along with the new rule requiring reports on major grants to divisions or departments, would go a long way to ensuring appropriate accounting in the future.

- **Dunlap Observatory sale**. There had been discussion of accounting for the money the University would receive from its sale of the Dunlap Observatory. The University, after paying all related closing costs, would receive $47-million from the sale, which would be placed into the endowment, and the income would be used to support astronomy-related academic activities. The external auditors had agreed with the accounting for this sale.

- **Investments**. Ms Tory noted that the audit of investments had been challenging for the current year because of the significant amount of non-publicly traded investments. The complete and accurate recording of the value of such investments was the responsibility of the custodial firm that held the funds. The difficulty faced by the custodian was the need to record closing bid prices as at the University's fiscal year end – a task that had to be achieved manually. To complicate matters further, the prices of the assets were identified in the foreign currencies in which the non-Canadian investments were held and required translation into Canadian currency. The University had to monitor to ensure that the records were accurate. It was therefore important that the prices be made available well in advance of the compilation of the financial statements so that any errors could be identified. In 2009, some errors had not been identified until the external audit. Ms Tory noted that it was highly atypical for such errors not to have been discovered before the audit, and she expressed her confidence that management was making every effort to avoid a recurrence. She noted that revision of the statements to reflect accurate valuations had required a great deal of time and effort on the part of the Financial Services staff.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(b) External Auditors' Report on Audit Results (Cont'd)

- **Benefit plans**. The auditors had discussed with management the accounting treatment of additional expenses and recoveries with respect to two benefit plans. Although both matters had arisen during 2008-09, both had affected the University's financial statements for the 2007-08 year, and the items were recorded in the summary of audit differences for that year.

  In response to a question, Mr. Piché said that the contributions not required to pay for medical benefits in 2007-08 had been set aside and held in trust for possible costs in excess of contributions in future years. Ms Tory noted that the auditors had also discussed with management the actuarial assumptions concerning the pension plans, including the discount rate on the liabilities, and had concluded that the assumptions used were reasonable.

- **Recording of externally restricted grants as deferred contributions**. The University's accounting treatment of unspent, externally restricted grants as deferred contributions continued, as discussed by the Committee one year ago.

- **Accounting policies**. The auditors had discussed with management (a) changes to the notes for 2008-09 arising from new accounting rules, and (b) changes to accounting policies that would affect future financial statements. In all cases, forthcoming changes would affect only disclosures but not the substance of the accounting for the University's operations or its financial position.

Ms Tory commented on audit differences. There had been no audit differences arising from the audit of the 2008-09 statements. In response to a member's question, Ms Tory said that a number of audit differences had come to light during 2008-09 leading to audit differences with respect to the financial statements for 2007-08. The amount involved was, however, small and well below the level of materiality.

Ms Tory drew the Committee's attention to the "Required Communications" contained in the Audit Report. Most of the matters had been raised earlier in the meeting. She then directed the Committee's attention to the letter on page 11 of the *Audit Results* report, which assured the Committee of the external auditors' independence. She asked members to raise any areas of risk that had not been addressed in the auditors' communications and to inform her of knowledge of any actual or suspected act of fraud. Members confirmed that they were aware of no such matters.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

(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.

(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."

Mr. Piché said that the number of legal claims had been declining. Three new claims had arisen during the year, which were highlighted in the report by underscoring. The amounts were minor relative to the claims made in previous years.

Arising from the discussion of one claim, a member expressed concern about the apparently continuing problem of employees being compensated for extra duties as contractors or consultants rather than as employees and therefore not having income tax and other statutory deductions withheld. Ms Brown and a member confirmed that the University's policy stance on the matter was unambiguous. That stance included a firm rule that compensation for any teaching in a degree program was to treat the faculty member as an employee. Mr. Britt said that there were, however, problems with compliance with the requirement. In light of the audit results, the Internal Auditors would seek to discover the extent of the problem. He was concerned not only about the potential University liability for the sums that should have been withheld but also about potential claims for employee benefits.

(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, 2009 be approved.

2. Audited Financial Statements for the Year Ended April 30, 2009 (Cont'd)

On behalf of the Committee, the Chair congratulated Ms Brown and Mr. Piché and members of their staff on their remarkable achievement in preparing of the University's highly complex financial statements in time for their approval at the June meeting of the Governing Council.

3. External Auditors: Appointment for 2009 – 10

Ms Brown said that the administration recommended the re-appointment of Ernst & Young as the external auditors of the University and its pension plans. University policy required a periodic full review of the appointment of consultants, and Mr. Piché had conducted such a review of the audit firm in 2004. He had consulted members of the University who worked with, or who relied upon, the work of the auditors, and the outcome had been a very high level of satisfaction. With respect to the appointment of external auditors, the administration proposed reliance on the advice of the U.S. National Association of College and University Business Officers. That Association recognized that post-secondary institutions were highly specialized institutions, and that only certain audit firms had specialists capable of providing excellent audit services. The Association did not, therefore, recommend the rotation of audit firms. Rather they recommended the rotation of the audit partner, perhaps every seven years. The University had a partner change in 2005, following the retirement of the partner in charge, Mr. Keith Bowman, when Ms Tory returned after several years to become again partner in charge of the University's audit. She was Ernst & Young's specialist in higher education, and the University was very fortunate to have her as the partner responsible for its external audit.

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, 2010; 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, 2010.

4. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2009

Ms Brown reminded members that the University's Borrowing Strategy, approved by the Governing Council in June, 2004, specified the University's maximum borrowing capacity. The administration completed an annual review of that strategy with a view to determining its continued appropriateness and prudence. That review was completed in the winter of each year and submitted to the Business Board. The Borrowing Strategy specified that the University's maximum borrowing capacity was equal to 40% of its net assets averaged over the previous five years. In addition, the University could arrange for internal borrowing from the Expendable

4. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2009 (Cont'd)

Funds Investment Pool to a maximum of $200-million. That was a conservative amount because the University was eager to maintain strong levels of liquidity – something that had served the University very well especially in the year just passed. For the 2008-09 year, the maximum borrowing capacity had been $748-million of external borrowing plus the $200-million of internal borrowing capacity for a total of $948-million. For the 2009-10 year, with the net assets as at April 30, 2009 included in the calculation and the net assets as at April 30, 2004 excluded, the external borrowing capacity remained very close to unchanged at $758-million, plus $200-million of internal capacity for a total of $958-million.

Ms Brown said that the purpose of the current report was to advise members of the status of the Long-Term Borrowing Pool – the sinking fund used to accumulate funds to repay the University's external borrowing when it becomes due. That external borrowing had begun with a bullet debenture issued for $160-million that was to be repaid in 2031. Subsequent debentures had been issued for 40-year terms, with repayment beginning in 2043. The University's financing of projects required the divisions responsible for those projects to make blended principal and interest payments on their loans, which repayments were placed in the Pool. The Pool was used to pay interest on the debentures and to cover issue costs and on-going direct costs such as the cost of credit ratings. The remaining amounts were invested in the Long-Term Capital Appreciation Pool (along with the endowment funds and the funds for the Supplemental Retirement Arrangement) and those funds would be used to repay the debentures when they become due. The report included an income statement and a balance sheet for the Long-Term Borrowing Pool. The main change noted on the financial statement was the flow-through of the $18.3-million investment loss for 2008-09. Fortunately, notwithstanding that loss, there was still an amount of $48.4-million set aside for repayment.

Ms Brown said that the question to be answered by the annual report was: would there be sufficient funds available in the Long-Term Borrowing Pool to repay the debentures when they become due? Several financial models had been developed to answer that question. The answer would, of course, depend on investment returns for the next twenty-two years. Some models showed that there would be more than sufficient funds. A few showed that there would be a shortfall. In the latter case, the University's fall-back position would be to reissue debentures to roll a part of the debt. None of the debentures was encumbered by covenants. The University's only obligations were to pay the interest regularly and to repay the principal when the debentures came due. The debentures were not secured by specific assets. There was a cross-default provision of $25-million if the University were to default on some other obligation.

5. Risk Management and Insurance: Annual Report, 2008-09

Mr. Fleming presented the annual report on risk management and insurance.

- **Move to commercial insurance**. As at January 1, 2008, the University had moved its key property and liability insurance from the Canadian Universities Reciprocal Insurance

5. Risk Management and Insurance: Annual Report, 2008-09 (Cont'd)

Exchange (CURIE) to the commercial market. The new policies purchased had run from January 1, 2008 to April 30, 2009 so that future policies would correspond to the University's fiscal year. As a result, the University had only one month ago completed its first renewals. Notwithstanding the turmoil in the financial markets, including the insurance industry, the University had been able to achieve its policy renewals at a favourable rate, reflecting in good part its favourable claims experience. The University had retained most of the same insurers, apart from a couple of minor participants who had sought rate increases. The University's move to the commercial market had both given it the flexibility to purchase insurance that covered its specific needs and to gain the benefit of opportunities in the insurance market. The University had also reduced certain overstated insurance valuations, which had not previously been adjusted to reflect diminished insurable exposures. That was particularly the case for the insurance of the University's library collections, in which exposure had declined owing to the availability of materials in digitized form, which could readily be backed up in other locations.

- **Property and liability insurance**. For its main property insurance policy, the University had retained its limit of $500-million coverage per occurrence, with a deductible of $250,000 per occurrence. For its liability insurance, including "errors and omissions" liability and the vehicle fleet policy, the University had arranged "stacked" insurance policies that would provide total coverage of $35-million per incident. Mr. Fleming said that the University continued to be pleased with its commercial-market insurance program and by the excellent work of the University's insurance brokers.

- **Other insurance**. With respect to other aspects of the University's insurance program (including the boiler and machinery policy, the composite crime policy and the personal professional property policy) Mr. Fleming said that the 2008-09 year had been generally a good one, with smoother renewals and a favourable claims experience. The rates for renewal of the boiler and machinery policy had been high because of two large claims that had arisen in 2007-08, but Mr. Fleming was confident that the significant problems in the area were now likely to be over.

- **Self-insurance reserve**. The University's self-insured claims experience had been satisfactory and consistent with previous years. Members would recall that the University maintained a self-insurance reserve as a restricted fund to deal with claims below the deductible amounts of its insurance coverage and above the $2,500 share of the cost to be borne by the department involved. However, with continuing payouts and with investment losses on the fund for 2008-09, the balance had declined to an amount under $1-million as at April 30, 2009, and there was a clear need for a further infusion of funds. Mr. Fleming had alerted senior management to the need, and he was confident that the matter would be addressed appropriately.

5. Risk Management and Insurance: Annual Report, 2008-09 (Cont'd)

The following matters arose in questions and discussion.

(a) Broker compensation. In response to questions, Mr. Fleming said that the University's insurance brokers were not compensated by commission; rather they received an annual fee for their services, which Mr. Fleming considered to be a reasonable one. He had been assured that the brokers did not receive a contingent-fee commission from the insurance companies.

(b) Premium costs. In response to a question, Mr. Fleming said that the University's premium cost in CURIE had depended on the claims experience of all participating universities, with all participants having to pay a fair share of the costs of claims. It happened that the CURIE participants overall were currently going through a difficult period. The University, in moving from CURIE, had sought to differentiate itself and to present itself as a preferred risk. It had been successful in doing so to date, but its premium rates in the future would depend on its claims experience.

(c) Policy deductibles. A member observed that the deductible amounts on the University's policies were small relative to the size of the institution. Ms Brown replied that a part of the University's strategy in leaving CURIE had, in fact, been to gain the flexibility to increase its deductibles. Before it could do so, however, it had to increase the funds available in the internal insurance reserve. The $250,000 deductible had been the maximum permitted by CURIE rules and had been unchanged for many years. Therefore no further premium savings had been available for increasing it. In addition, the low internal deductible amount put more strain on the self-insurance reserve. In considering change, however, the University had reached the conclusion that the divisions and departments had, at this time, too many other financial concerns and risks to increase their vulnerability by increasing the amount of the internal deductible.

6. Internal Audit: Annual Report, 2008-09

Mr. Britt presented the Annual Report of the Internal Audit Department for 2008-09. He referred the Committee to Table 1 indicating the number of audit hours completed. While the Department had been productive, its output had been adversely affected by two factors. First, two staff members had been away on maternity leave, and contract auditors had only partially filled the gap. (In response to a subsequent question, Mr. Britt said that the Department was currently at full complement.) Second, a considerable amount of time had been required for five special reviews. Mr. Britt had re-arranged the Department's priorities, and the Department had been able to address the key areas of risk. Mr. Britt also referred to Table 2 concerning audit reports. Reporting had continued to evolve, and in some cases, where there was no finding of significant risk or other audit issues, less stress had been placed on formal reports and more on hands-on guidance to the department in the form of discussions, memoranda or other types of direction. Mr. Britt summarized the substantive matters in his report.

- **Departmental audits**. Schedule 1 to the annual report listed the departmental audits that had been completed, that had proceeded to the stage of a draft report, or that remained in progress. The list included the rankings assigned for the completed audits, based on the

6. Internal Audit: Annual Report, 2008-09 (Cont'd)

effectiveness of the department's internal controls in managing the risks identified. Three of the units had been classified as needing improvement. In two ancillary operations, there had been problems with respect to procedures for cash handling and controls over cash. In one information-technology services area, processes for backing up data had not been tested, and they had failed when tested by Internal Audit. In all cases, management had agreed to address the problems. Two units had, on the other hand, been classified as having strong procedures and internal controls. Others had been classified as adequate. That classification indicated some deficiencies in procedures or controls that should be addressed but were not critical.

- **Continuous auditing**. The internal auditors had on a monthly basis reviewed samples of selected types of transactions in University and research funds. The transactions were examined for conformity with University policy and, for research funds, also with sponsor policy. They were also examined for propriety and for conformity with good business practices. A sample of 353 transactions had been reviewed, and one or more exceptions had been found in 113 of the transactions, for a 32% exceptions rate. That represented some improvement over the previous year, but the rate was still higher than one with which Mr. Britt would be comfortable. The Chair said that the exceptions rate was very high.

- **Special reviews**. The Department had undertaken five special reviews during the year. Two had been in response to management requests for assistance. Three had arisen from allegations of suspected or actual misappropriation or fraud. None had involved significant amounts. In response to a question, Mr. Britt said that the allegations had concerned three different departments. There had been no pattern involved.

Mr. Britt concluded that the internal audit results indicated no unreasonable level of financial or operational risk in the units that had been audited. In so large and complex an organization, the audit findings were probably at a level to be expected. There was no need for new policies or procedures. Senior management took the audit findings into account in their risk-assessment process, leading to appropriate measures to mitigate risk. Mr. Britt did think, however, that central monitoring and oversight could be strengthened. Ms Riggall, Ms Brown and Mr. Britt had considered various software tools that could be used to monitor controls and compliance, but their cost was quite substantial. There should, however, be some other less expensive means of improving central monitoring. With greater central monitoring and awareness of it, it was likely that a higher level of compliance with policies and procedures could be achieved.

A member referred to Mr. Britt's concern about the cost of certain tools for central monitoring and oversight. She asked whether Mr. Britt might be able to comment on the financial cost of not having an appropriate level of monitoring. If the cost of misappropriations was substantial, then the cost of preventive action would be well worthwhile. Mr. Britt replied that he could not at this time project from his findings to produce a reasoned estimate of the cost of non-compliance. Going forward, however, Mr. Britt anticipated that new methodologies to be employed in the continuous audit would enable him to provide a dollar estimate of the cost of non-compliance.

6. Internal Audit: Audit Plan, 2009-10

Mr. Britt presented his Internal Audit Plan for 2009-10. The two staff members who had completed their maternity leaves had asked to continue their employment on less than a full-time basis. Mr. Britt had engaged a contract auditor with a long-term commitment who would be able to make up the number of hours released as a result of the new employment arrangements for the continuing staff members. The Internal Audit Plan anticipated the delivery of the same number of audit hours as in 2008-09. The scope of audit activities would continue as in previous years, including assistance to the external auditors and the continuous auditing program. Mr. Britt hoped that the number of hours required for special reviews would be fewer than required in 2008-09. He commented on the areas selected for audit reviews, including areas where reviews begun in 2008-09 would be continued and areas where new reviews would be initiated. He noted that he hoped to engage consultants (a) to undertake a broad ranging review of the University's supply-chain management policies, procedures and controls, and (b) to produce an enterprise fraud-risk assessment. Funding for the engagement of consultants would be available as the result of a member of the Internal Audit Staff's being released to the Vice-President, Human Resources and Equity for assistance in her development of the University's crisis-management plan.

Ms Riggall reported that the Government of Ontario had undertaken a substantial initiative in the area of procurement in the broader public sector. It had initially moved to set out policy guidelines in the area, which might in the future become mandatory. The Government had taken the view that there might well be substantial savings available from collaboration within the broader public sector in its procurement activities. Ms Brown reported that the activity had led to the establishment of an Ontario Education Collaborative Marketplace and an Electronic Marketplace for educational institutions. The idea had been originated by a number of procurement managers, who had met with officials from the Ministry of Finance and had secured funding for the initiative. While the establishment of the new bodies had been very difficult, there was a potential for real benefit. Ms Riggall noted that especially in the light of the likely need to respond to this initiative, it would be important that the University have strong baseline data about its own procurement processes.

Mr. Britt drew the Committee's attention finally to plans concerning a review of off-payroll payments to individuals – a subject of previous discussion. The Internal Audit Department would use data-mining tools to review the matter and to determine the need for further action.

7. Report of the Administration

Ms Riggall, Ms Brown, Mr. Charpentier and Mr. Britt said that they had no other items that should be drawn to the attention of the Committee at this time.

8. Date of Next Meeting

The Chair said that the Committee’s meeting schedule would be distributed to members over the summer.

9. Other Business: Chair's Remarks

The Chair thanked all members for their service over the year. He offered special thanks to two members completing their terms of service to the Committee:

- **Ms Dominique Barker** would be starting in a new position this fall at Hydro One, and she wished to give it her full focus for the year.

- **Mr. Paul Lindblad** had been a member of the Committee for nine years, which was the maximum term for members of the Governing Council and was usually regarded as the maximum term on a Committee.

10. Internal Auditor: Private Meeting

Members of the administration, the Secretariat and the external auditor absented themselves.

THE COMMITTEE MOVED IN CAMERA.

The Committee held its regular private meeting with the internal auditor. The meeting was intended to enable the internal auditor (as provided in the Committee's terms of reference) to report on “any problems encountered, any failure to provide appropriate information or any restrictions on internal audit work, the general co-operation received in the performance of internal audit duties, and any matters requiring discussion arising from the auditor’s findings.”

THE COMMITTEE ENDED ITS *IN CAMERA* SESSION.

The meeting adjourned at 6:30 p.m.

Secretary	Chair

August 26, 2009

52073