UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 92 OF THE AUDIT COMMITTEE

December 8, 2009

To the Business Board,
University of Toronto.

Your Committee reports that it met on Tuesday, December 8, 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
Mr. J. Mark Gardhouse
Mr. W. John Switzer

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 Shirley Hoy
Mr. Joseph Mapa

In Attendance:

Mr. Pierre G. Piché, Controller and Director of Financial Services
Mr. Allan Shapira, Hewitt Associates
Ms Martha Tory, Ernst & Young

1. Chair's Remarks

The Chair welcomed members to the first meeting of the year. In particular, he welcomed two new members of the Committee: Mr. Mark Gardhouse and Mr. John Switzer. 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 91 (June 17, 2009) was approved.

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

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009

The Chair said that the Committee's primary responsibility with respect to the Annual Financial Report on the Pension Plan was consideration and recommendation of the approval of the audited financial statements of the two registered pension plans. The Committee was more generally responsible to satisfy itself, the Business Board and the University that the Annual Report fairly presented the financial position of the pension plans.

Ms Brown noted that 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 OISE faculty and staff 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 of the main registered plan and the OISE plan. Ms Brown summarized the highlights of the annual report. Among those highlights were the following.

- **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 rate of salary increases, retirement ages and life-span. The liabilities represented the plans' needs in order to make pension payments. The plans' 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 market 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 of the registered pension plans provided an audited value for their assets as at June 30, 2009. Second, the report included the three funding valuations prepared by the actuaries. The first valuation was the going-concern valuation. That valuation was the focus of the discussion throughout the text of the report, given the assumption that the University and its pension plans would remain going concerns 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 registered plans as it would have been had the plans been wound up as of July 1, 2009 and had the University purchased annuities or made lump-sum settlements to provide the promised benefits, apart from partial indexation. The third valuation was a hypothetical wind-up valuation, based on the premise that the plans were wound up as of July 1, 2009 and annuities purchased or lump sum payments made to

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

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 difference between the numbers in the University's audited financial statements and in this report. That was the case for 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, in accordance with accounting requirements, were not included in the pension plan numbers.

- **Summary of pension funding status as at July 1, 2009**. As at July 1, 2008, the University's pension plans had been in almost a break-even position, with the market value of the assets only about 4% less than the combined liabilities. (For the previous year – that ending July 1, 2007 - the combined plans, as well as each of the plans individually, had been in a surplus position.) However, the large negative investment returns in 2008-09 had led to a large combined deficit amounting to just over $1-billion. The University's financial statements had shown a negative return of -31% as at April 30, 2009. There had been some pick-up in May and June, but the negative investment return for the year ended June 30, 2009 was still -27%.

  Ms Brown stressed that while the report focused on the positions of the plans taken together, each of the registered plans was legally a separate trust. The Supplemental Retirement Arrangement, in contrast, was not a registered plan, and the new pension reserve simply represented additional funding set aside by the University for any pension purpose. The University could add money to the amount it had set aside in a "fund for special purposes" to meet its obligation under the Supplemental Retirement Arrangement, and it could remove money from that fund. It could not, however, move money from the registered plans. In evaluating the overall financial health of the pension plans, however, it was important to look at the totals for all plans together.

- **Liabilities**. Referring to a ten-year graph, Ms Brown said that the liabilities of the plans had grown steadily. One of the factors was the steady growth in the number of participants in the plans, with an increase of 342 participants in 2008-09. A number of the pension plans that had encountered severe problems were those in which the active membership was declining. The University's plans, in contrast, had a significant number of new, young members, who were increasing the level of contributions to the plans. That was an important factor to be aware of in evaluating the financial health of the plans.

  In response to a question, it was noted that the OISE plan had been closed as at June 30, 1996. New faculty and staff at OISE joined the main University plan. Therefore, the number of participants in the OISE plan was declining slowly - by four during 2008-09.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

There had been no changes to pension benefits or to the actuarial assumptions in 2008-09.

- **Assets**. Referring to a graph of the value of pension plan assets for the past ten years, Ms Brown said that 1999-2000 had been a very good year on the securities markets. The value of the assets had subsequently declined from 2000-01 to 2002-03. Following that decline, the value of the assets had increased as the result of good investment returns from 2003-04 to 2006-07. That in turn was followed by the negative return in 2007-08 and the severe decline in 2008-09.

  Ms Brown outlined the basis of the change in the assets over the 2008-09 year. Contributions had been made to the plan amounting to just under $135-million. The plans' investments had, however, declined in value by 27.6%, net of fees and expenses. That compared with a negative return of -5.9% in 2007-08. Payments to pensioners had amounted to $141.3-million, an increase from $136.4-million the previous year. Fees and expenses had amounted to 1.47% of assets in 2008-09, compared to 1.04% the previous year. The growth of fees was attributable in good part to the reduction in the denominator: as the total value of the assets had declined over the year, the proportional cost of their management had increased.

- **Market surpluses and deficits**. Referring to a ten-year graph of the surplus / deficit position of the combined pension plans, Ms Brown pointed out that the surplus in the plans had reached a high point in 2000, amounting to $591-million. That surplus had declined over the next two years, with the combined plans then falling into a deficit of about $214-million beginning in 2003. That decline had represented a shift of $805-million in the funded position of the plans. The combined plans had then returned to a surplus of nearly $225-million in 2007, before their decline, eventually to their July 1, 2009 deficit in excess of $1-billion. The impact of the ups and downs of the investment cycles was clearly evident in those figures.

- **Contributions**. In the first two years of the decade, the plans had been in a substantial surplus position, and both the University and the employee groups were enjoying a pension contribution holiday. Such a holiday was required of the employer because the registered plans' surplus exceeded the amount of their accrued liabilities by more than 10%. The employee contribution holiday had been negotiated by the organizations representing University faculty and staff. Contributions had then begun to ramp up in 2001-02. In 2003-04, the University had also begun to make a special plan contribution, now amounting to $27.2-million per year, as part of the new Pension Funding Strategy approved by the Business Board. Such an amount was far in excess of the required additional contribution at that time. The objective of the special additional funding was both to deal with the small deficit at the time and to build up a reserve for the future.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

The Policy permitted the University to pay the additional amount into the registered plan, to invest it in the special fund designed to deal with the University's liability under the Supplemental Retirement Arrangement, or to set the money aside in another special reserve.

Ms Brown said that each employee's contribution to the plan was determined by a formula. Employees would contribute either 4% or 5% of their salaries up to the maximum pensionable earnings under the Canada Pension Plan, depending on their employee group, and then 6% of earnings above that maximum. The University would then contribute whatever additional amount was required both to pay the current service cost of the plan and to deal (over a period of time) with any deficit. The contribution ratio over a twenty-five year period ending in 2011 would be two dollars contributed by the University for every one dollar contributed by the employees.

Ms Brown displayed a ten-year graph showing the destination of contributions: (a) to the registered pension plan, (b) to the OISE plan, (c) to the special fund to deal with the University's obligation under the Supplemental Retirement Arrangement, or (d) beginning in 2008-09, to the pension reserve fund. Previously, the monies that had not been required for contribution to the registered plans had been placed in the fund for the Supplemental Retirement Arrangement. The Pension Reserve Fund had been established in the current year, with that fund being invested in short-term securities to provide liquidity for University contributions over and above the current service costs of the plans.

- **Investment earnings**. Ms Brown displayed a graph showing the investment earnings of the Pension Fund Master Trust (the fund used for the investment of the funds for the two registered pension plans) over the past ten years. The investment objective for the pension funds, currently reflected in the actuarial assumptions, was a real return (i.e. a return after the effect of inflation and after all fees and expenses) of 4% per year over ten years. With an expected rate of inflation of 2.5% per year, the objective would be achieved with a nominal return of 6.5% per year plus fees and expenses. The risk tolerance was a standard deviation of no more than 10% over ten years (i.e. a return within 10% greater or less than the return objective two thirds of the time over a ten-year period). In fact over the previous ten years, the investment returns had remained within the risk corridor in five years, had exceeded it for two years and had fallen below it for three years, including 2007-08 and 2008-09.

- **Impact on contributions of changing the assumed investment return**. It had from time to time been suggested that the University consider reducing the actuarial assumption for the investment return objective. For 2009-10, using the assumption of a 4% annual real rate of investment return (after inflation and after fees and expenses), the employer's annual current-service cost for the main registered pension plan would be $73.1-million and the employee current-service cost would be $35.2-million. If the employee current-service cost had remained fixed, according to the current formula based on employee

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salaries, and if the investment return assumption had been reduced to a real return of 3.75%, then the employer current service cost for 2009-10 would have been increased from $73.1-million to $78.6-million. It the return assumption had been reduced further to what could be described as the return on a minimum risk portfolio, currently estimated at a real return of 2% per year, the employer current-service cost for the year would have been increased to $135.8-million. The impact of such cost increases on the University's operating budget would have to form a part of the debate on any proposal to reduce the assumed rate of investment return.

- **Pension payments**. Pension payments had increased steadily and dramatically over the past ten years, from a total of $70.8-million for the University's three pension plans in 1999-2000 to $141.3-million in 2008-09. This increase had reflected the growth in the number of retired members of the plans, the increase in their pensions owing to the partial indexing provision in the plan (an especially significant factor in the earlier years of the decade) and the increase in actual and expected lifespan.

- **Fees and expenses**. Ms Brown displayed a graph of fees and expenses, which had increased from 0.22% of assets in 1999-2000 to 1.47% of assets in 2008-09. At the time of the establishment of the University of Toronto Asset Management Corporation (UTAM) in 2000, the pension assets had been invested primarily either by local balanced-fund managers or in index funds. UTAM had been established to provide for more active management strategies and for the use of different kinds of investments. That involved more cost, particularly as UTAM moved to invest in alternative asset classes such as hedge funds and private equity. For private-equity funds, managers charged fees based on the investors' total commitments, but the returns on those investments did not materialize for a number of years. While the value of the plans' overall assets had declined in 2008-09, the cost of their management had not fallen correspondingly because the fees for some categories of investments, especially private equity, had not declined. The cost of UTAM's operations themselves were small. Its staff consisted of twelve people. UTAM staff recommended asset mix to the UTAM Board, hired and oversaw external managers to invest all assets, and maintained a compliance function to ensure the integrity of those assets and their investment in accordance with agreed conditions. In response to a question, Ms Brown said that there was currently a large number of external managers, in particular because hedge-fund investments had originally been made in funds of hedge funds. The current UTAM management was moving to simplify the portfolios, with some overall reduction in the number of managers, and it was moving to reduce investments in hedge funds and to invest primarily in individual funds rather than funds of funds.

- **Going-concern and solvency valuations**. Ms Brown stressed that the report on the funding status of the plan had been based on the going-concern actuarial valuation, which assumed that the University and its pension plan would continue operations indefinitely. While the going-concern liability as at July 1, 2009 was over $1-billion, the going-concern funding rules allowed the University fifteen years to bring the plan back to a fully funded

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basis. The solvency valuation was based on the hypothesis that the University had ceased operations on the July 1, 2009 valuation date and that the pension plan had to be wound up, with benefits settled through the purchase of annuities or the payment of lump sum values. Those benefits did not include the University's provision for partial indexing against inflation. While the deficit according to the solvency valuation was $880-million, and therefore less than the going-concern deficit, the Pension Benefits Act required that it be eliminated over five years rather than fifteen. With the agreement of employees, that period could be extended to ten years under funding relief provisions introduced in the 2009 Ontario budget.

- **Market developments in late 2009**. Ms Brown noted that the equity markets had experienced moderate growth in the latter half of 2009, continuing the upward trend in place since the end of March 2009. For the three months from June 30 to September 30, the return had been 5.5%. The preliminary four-month rate of return from June 30 to October 31, 2009 had been 4.7%. The consequence was movement in the right direction to reduce the deficit in the plans. In response to a question, Ms Brown said that UTAM had undertaken a number of changes including: a pause in further commitments to private equity investments; a reduction in the investments in hedge funds, and the move towards more direct investment in individual hedge funds rather than funds of funds; changes in currency hedging; and fixed-income investments designed to take advantage of credit spreads in the market.

- **Uncertainties concerning the choice of funding and investment strategies**. Ms Brown said that the University had been considering various options to respond to the fund deficits. It was important to bear in mind that the University had filed its plan valuations with the Financial Services Commission of Ontario as at July 1, 2008 and that, absent plan changes, it would not be required to file a further valuation until July 1, 2011. The University had in place its current funding strategy which included in the operating budget a special allocation for pension purposes of $27.2-million per year over and above current service costs. That strategy would remain in place beyond July 1, 2011. Leading to July 1, 2011, the University was evaluating a variety of options to deal with the issue of funding the pension plan. In the meanwhile, the University hoped that a number of important uncertainties would be resolved. Many of the issues involved were very important to all defined-benefit plans, virtually all of which faced deficits of various amounts. The University was fortunate to have had its funding strategy in place since 2004, with its provision of a special base-budget allocation.

  The first set of uncertainties concerned legal and regulatory requirements. The Government of Ontario had received recommendations on pension reform from the "Arthurs Commission" – an expert Commission that had made recommendations concerning pension regulation. The Ontario Ministry of Finance had been promoting the idea of the amalgamation and joint management of the Ontario universities' pension funds, based on the premise that "bigger is better" – that a combined pension trust could take advantage of economies of scale. Such a fund could be managed by an existing organization such as the

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Ontario Teachers' Pension Plan or the Ontario Municipal Employees' Retirement System (OMERS) or by a new multi-institution management company – one similar to or even based on UTAM. The Council of Ontario Universities was at the same time seeking an exemption for the universities from the current solvency funding requirements. Such an exemption would give the universities more time to eliminate their solvency deficits. Such exemptions had been granted, to date, in four other provinces. Because the universities' income (from government per-student grants and from tuition fees) was largely controlled by government, the only way the Ontario universities could meet the current solvency funding requirements for their pension funds would be to devote large amounts of money in their operating budgets to that purpose – something that would be antithetical to the Ontario government's objective that the universities increase accessibility and improve the quality of students' educational experience. The universities, unlike private-sector plan sponsors, did not realistically face the risk of having to wind up their operations.

There were also substantial uncertainties within the University itself. First, an arbitrator's award, arising from salary and benefits negotiations between the University and the Faculty Association, had provided for the formation of a Pension Committee of the Governing Council that would include representatives of the faculty and other employees as well as members of the Council. The objective was to provide a stronger voice for members of the pension plans in their management. It was hoped that members with different perspectives would provide a better understanding of the plans amongst all concerned, for example an understanding of the cost and impact of benefit improvements and an understanding of the relationship between return and risk in the management of the plan assets.

Second, the University was reviewing its investment return targets and its stated risk tolerance going forward. Some had expressed support for increasing risk tolerance to enable the Pension Fund Master Trust to take advantage of the current "down" market conditions. Others favoured a more conservative policy. It was always necessary, in considering options, to take into account the effect of any combination of return objective and risk tolerance on the level of required contributions. While some work had been completed, there was need for a new asset/liability study, laying out a series of risk levels, their consequences, and the probability of those consequences. The previous study had concluded, for example, that there was a 36% probability that the University would have to increase the amount of its special $27.2-million pension contribution budget by 2011. In response to a member's question, Ms Brown said that the review of the investment return objective and risk tolerance would require the completion of substantial staff work, then discussion at the senior level of the University's administration, and finally discussion with the divisions. Ultimately, any costs arising from changes to the investment objectives would have to be reflected in the University's budget and would thus have an impact on the divisions. Ms Riggall stressed that it would be very important to make clear, in concrete terms, the meaning of the risk that would have to be assumed to have the likelihood of attaining a given level of return.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

Ms Brown said that the final source of uncertainty within the University was the recommendations of, and the changes that might arise from the work of, the President's Advisory Committee on Investment Policies, Structures, Strategies and Execution.

Ms Brown concluded that the level of uncertainty was, therefore, high. Added to that was the uncertainty of the direction of the financial markets themselves. Would the markets continue their recovery, or would they decline? Because of the level of uncertainty, the administration had identified various possible solutions, and the likely outcome would be some combination of them. For example, the University could consider selling particular assets if it became necessary to do so to deal with the solvency deficit. Alternatively it might place a University asset into the registered pension plans. For example, it could place the assets now set aside to meet the University's obligation under the Supplemental Retirement Arrangement into the pension plan, meet the S.R.A. obligation from the operating budget, and later over time restore the special S.R.A. fund. Ms Brown noted that the limit in the Income Tax Act on pensionable income for registered plans, now $133,000, was being increased gradually year by year. If that process continued, there would be no new liability under the S.R.A. by 2013-14, as the maximum pensionable income of $150,000 covered by the S.R.A. would be reached. If necessary, the University could consider borrowing to meet its pension plan solvency obligation. It could increase the amount of its special budget appropriation under the Pension Funding Strategy from the present $27-million to an amount specified as a percent of the salary base. That method of dealing with the problem would be a more gradual and less painful one, but it would require a longer period of time than the time currently permitted under the solvency funding rules. The revised pension funding strategy would need to be ready for implementation effective July 1, 2011 (absent any changes to the registered plans in the interim).

Mr. Shapira commented that while a recovery in the financial markets could absorb some of the unfunded liability, it should be expected that at least half of the deficit would have to be made up from special payments. Continuation of the current special contribution of $27.2-million per year over a twenty to twenty-five year period would deal with $350-million of the problem, and a slightly higher annual special contribution would deal with $450-million. The question was whether the Government would provide sufficient time for such a solution. Whatever steps might be necessary to deal with the immediate solvency valuation problem, it was important first of all to have the appropriate long-term funding and investment strategy in place.

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

(a) Effect of the end to mandatory retirement. A member asked about the effect on the plans' liabilities of the legislated end to mandatory retirement. Ms Brown replied that modeling had shown that there would likely be very little impact. While some members of the plans were choosing to retire early, others were waiting until they were past age 65 to retire. It was, however, too early to know definitively what the effect would be. Mr. Shapira elaborated. If members of the

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

plans postponed their retirement, they would earn increased pension benefits, but their late start to collecting those benefits would offset the increased amount of those benefits. It appeared likely that the University's plan would be less influenced by the cost of early retirement provisions than many of the other large public-sector plans. Members of the faculty were continuing to retire at an average age of approximately 65 years and members of the administrative staff at approximately 62 years. The plans that had encountered problems were those in which large numbers of plan members took early retirement. When the end of mandatory retirement had been legislated in 2005, the actuaries had factored in the likelihood of a somewhat later average retirement date. The effect had been a slight reduction in the overall liability of the plans.

(b) Consideration of a defined-contribution plan. A member asked whether consideration had been given to moving to a defined-contribution plan. Ms Brown said that the option had not been considered at the University of Toronto in recent years. At one stage, during a period of strong market returns, the Faculty Association had raised the possibility of such a plan being offered as an option, but the idea had not been pursued. Ms Riggall noted that some other universities had been considering offering such a plan for new employees.

Ms Tory addressed the letter from Ernst & Young, dated November 20, 2009, containing required communications to the Audit Committee. She said that the key focus of the audit was the pension plan's investments and their valuation. In performing the audit, Ernst & Young had updated its understanding of the investments from the work it had completed two months previously in performing the audit of the University's financial statements. The University of Toronto Asset Management Corporation managed the assets of both the pension plan and the University's Long-Term Capital Appreciation Pool, and UTAM managed both funds in a similar way. The audit of the publicly traded investments was a relatively simple one, but the audit of alternative investments required more attention as they were not valued in a straightforward way by a public market. The auditors were comfortable with the valuation of those investments and they were comfortable that they were fairly presented in the financial statements. Ms Tory requested: (a) confirmation that the Committee had no concern with respect to the audit approach or with respect to risk issues that had not been identified, and (b) confirmation that the Committee and its members were not aware of any fraud or illegal acts that would have an impact on the financial statements. Members raised no area of concern.

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, 2009, be approved, and

(b) THAT the audited financial statements for the University of Toronto (OISE) Pension Plan, June 30, 2009, be approved.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2009 (Cont'd)

Ms Brown thanked Mr. Piché and his staff, Mr. Shapira, and Ms Tory for their efforts in producing this major annual report. The Chair and members echoed this thanks. They described the report, and its presentation, as an excellent one that had improved even further each year.

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 had been revised substantially in June 2006. They were brought forward to the Committee for information and review each year. A Task Force on Governance was in the process of reviewing the terms of reference of all Boards and Committees, and that review provided an opportunity for the Committee and its members to propose any amendments that were appropriate at this time.

A member proposed a revision to Section 5.1.4 (Financial Controls and Control Environment), part (a), to state that the Committee:

> Periodically reviews management reports on control systems and the control environment, including the interim and annual reports from the internal auditor, the annual management letter from the external auditors and other relevant reports that evaluate the effectiveness of the University's control systems.

The member's intention was to make it clear that the Audit Committee reviewed reports on the effectiveness of controls, but it did not itself make an independent assessment of them.

The Chair asked Mr. Charpentier to convey the suggestion to the Task Force on Governance, and he invited members with any other suggestions to pass them to him, to Mr. Charpentier or to the Secretary of the Committee.

5. Calendar of Business, 2009-10

The Committee received for information its Calendar of Business for 2009-10, showing the items planned to come before the Committee.

The Chair noted that the March 8, 2010 date was a reserve date. While there was at present no business requiring the Committee's attention, members were asked to hold that date open on their calendars in the event that business arose that would require the Committee's attention. With respect to the May 12, 2010 date, it might well be necessary to

5. Calendar of Business, 2009-10 (Cont'd)

begin the meeting a bit earlier than the usual 4:00 p.m. time to avoid a scheduling conflict with the Women of Distinction Dinner to be held on the same date. The final meeting of the year, scheduled for June 16, 2010, would have a substantial agenda, including the University's audited financial statements for 2009-10.

6. Internal Audit Department: Semi-Annual Report, October 31, 2009

Mr. Britt presented the Internal Audit Department's Semi-Annual Activity Report for the six months ended October 31, 2009. He noted that the Department had completed 60% of the audit hours provided in the annual Audit Plan. It had, however, been necessary to reallocate hours to work on seven special reviews. Those reviews had arisen from reports of suspected improprieties or from the findings of department and continuous audits. Five of the seven reviews were still in progress as at the date of Mr. Britt's report, and the special reviews and other special work had used 24% of the audit hours provided in the six month period. A further 52% of the audit hours had been devoted to department and follow-up reviews; 15% of audit hours had been used to assist with the external audit (reducing the external audit fee); 8% of hours had been used for the continuous audit process; and 1% of hours had been spent on review work related to information systems. Given the Department's budgetary and staffing limits, it would be very challenging to complete the full audit plan for the year. The Department would continue to focus its time on areas with the highest risk and on any special situations that might arise.

Mr. Britt reported on the Department and Information Systems audits completed during the six months ended October 31. As had been requested by the Committee, he elaborated on the outcome of the audits of two units where internal controls were deemed to require improvement in order to safeguard assets or to ensure compliance with University policies and procedures and with good business practices. In response to a question, Mr. Britt said that the Internal Audit Department completed follow-up reviews after all departmental audits to determine compliance with the recommendations of the initial audit. Follow-up reviews of divisions where internal controls were judged to be in need of improvement were given very high priority. Mr. Britt assured the Committee that he had been dealing with the management of the two units, and both were making good efforts to address the issues raised in the initial audit. It was proposed by a member and AGREED that the Internal Audit Department report back to the Committee on the outcome of follow-up reviews of units in any case where their internal controls were placed in the category of "needs improvement." In particular, the follow up report to the Committee would deal with the number of significant recommendations, the number implemented, and the number where implementation had been undertaken but not yet achieved.

In response to a member's question, Mr. Britt said that there were usually not large amounts of money involved in cases where controls were found to be in need of improvement. Most often, the problem was a procedural deficiency, such as the absence of adherence to particular procedures, the lack of appropriate segregation of duties, or the lack of appropriate

6. Internal Audit Department: Semi-Annual Report, October 31, 2009 (Cont'd)

monitoring by an officer of the unit. Ms Riggall noted that it was often the case that appropriate procedures were not followed with respect to smaller rather than larger matters.

Mr. Britt reported on the outcome of the continuous auditing process. That process evaluated a sample of detailed transactions of particular types from all units across the University. The evaluation considered compliance with University policies and procedures, the propriety of transactions, and their appropriate authorization. The process was followed by a report back to the initiators of the transactions. The Internal Audit Department regularly reviewed executive management expense reports. The reviews for the period had revealed no significant problems. The Department had also reviewed the process for the University's making payment directly to the American Express Company for University expenses charged by University corporate cardholders. The process allowed the cardholder to request the University to pay the expense directly to the credit-card company so that the cardholder would not have to fund the expense personally and subsequently request reimbursement. The audit had brought to light a number of issues. In particular, there was no clear definition of the expected procedures for cardholders to follow in using this process. Those procedures included obtaining approval for the expense from an appropriate officer of the unit, documenting the expense, and claiming reimbursement for it, including provision of a declaration that the expense complied with University policies. Those procedures were the same as those required for the older process of claiming reimbursement for expenses.

A member asked whether officers responsible for units with those problems had signed annual administrative accountability reports. If so, she would be concerned about taking comfort from the program of those reports. Mr. Britt replied that in many cases accountability reports had been signed. However, the problems revealed by the audit were often inappropriate completion of procedures, for example delegation of authority for approval of expenses by lower level staff.

A member noted that corporate credit cards were from time to time a source of substantial financial vulnerability, particularly in cases where disgruntled employees left their jobs.
Mr. Piché said that in the case of the American Express corporate cards, the employees were personally liable for paying their card balances. They had either to request the University to make payment or (using the older process) to provide reimbursement, but only for properly authorized and documented expenses.

Mr. Britt reported on the status of the Internal Audit Departments' audit plan. He drew members' attention to two audits that were in progress – both of an atypical nature that represented novel approaches, and both at the enterprise level. The first was the review of procurement governance and spending – a review of the University's policy, compliance and activities. The second was an assessment of fraud risk, seeking to determine where vulnerabilities existed in the University's processes and information systems. Mr. Britt would report to the Committee on the outcome of those reviews at a meeting in the spring term.

6. Internal Audit Department: Semi-Annual Report, October 31, 2009 (Cont'd)

Finally, Mr. Britt reported on the seven special reviews that were in progress during the reporting period. He stressed that the University did have a process in place for employees to report suspected financial improprieties. Internal Audit procedures were becoming more refined, leading to the detection of improprieties in the course of departmental audits and continuous audits. He noted that the special audits were very demanding of Internal Audit resources. Following Mr. Britt's report, the Chair said that it was a comfort to know that the system was working and that Internal Audit was being asked to look into, or finding reason to look into, problematic matters.

7. Expense Accountability: Reports:

Ms Riggall reported that, because of certain highly public problems encountered by certain other organizations, the Chair of the Business Board had requested that a report be made to that Board on the requirements for accountability for expenses in the University. That report had been made to the Business Board at its November meeting. Because of the responsibility of the Audit Committee in this area, and because some members of the Audit Committee were not also members of the Business Board, a copy of that presentation had been included in the agenda package for this meeting. Ms Riggall, Ms Brown and Mr. Britt replied to a number of questions about certain detailed aspects of the presentation.

8. Administrative Accountability Reports: Annual Report on the Program

Mr. Piché presented the annual report on the program of administrative accountability reports for 2008-09. The President had reviewed the administrative accountability reports from those who reported directly to him, including the Vice-Presidents. There had been no negative responses. The Vice-President and Provost had received reports from Principals and Deans, which included only two negative responses out of a possible 364 responses. Replying to a question, Mr. Piché said that one Dean had delegated financial authority, but had failed to document that delegation in writing. Another Dean in a large Faculty had not, as required, personally reviewed the system-generated financial reports but had delegated that responsibility to the Chief Financial Officer in the Faculty. In both cases, the Deans had become aware of the appropriate procedures and responsibilities. The Chair observed that the outcome of the program was a very good one, with administrators in the University knowing and understanding their responsibilities.

9. External Auditors: Engagement Letter, Audit Plans, Report on Accounting Developments, and Report on Audit 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. The areas of risk identified were also consistent with the previous year. With respect to the audit fees, there would be only the customary increase to compensate for inflation. The auditors had begun to discuss the audit with management. For the current year, Mr. Piché had identified only

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

a single issue for discussion, in contrast with about ten the previous year. Ms Tory noted that the document provided the details of fees for various audits, in addition to the main operating fund audit, to be carried out in the coming year.

Ms Tory asked members to identify any areas not covered in the letter from Ernst & Young that the members believed should receive audit attention, including any areas of particular risk. No member proposed any area for attention.

In response to questions, Ms Tory said that non-audit services to the University were largely in tax-related areas. The firm completed a separate audit of the accounts of the University of Toronto Asset Management Corporation. The corporation itself was a relatively small operation with straightforward accounts. The assets they managed were carried on the books of the University or the pension funds, and they were included in those audits. There was a separate audit of the University of Toronto Press Inc. Its cost was more than half of the cost of the University audit for several reasons. Because the Press was a much smaller operation, it had a lower level of materiality. Its accounts included a number of complex areas including a large inventory of various kinds of goods and it included significant accounts receivable. In addition, it carried out a number of different lines of business. Ms Riggall noted that it had also completed an acquisition and a divestiture during the year. Ms Tory added that the fee for the University audit was kept to a lower level owing to the truly exceptional work completed by Mr. Piché and his colleagues in preparing the University's books for audit.

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, 2010, as outlined in the report from Ernst & Young dated December 8, 2009.

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

The Committee received for information the audited Enrolment Report, which was prepared each year for the Ministry of Training, Colleges and Universities. Ms Brown said that the report confirmed the number of students in various categories of programs, which was the basis of the University's claim for operating grants.

11. Dates of Next Meetings

The Chair reminded members that they were asked to set aside time for a meeting on **Monday, March 8, 2010 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 **Wednesday, May 12, 2010 at 4:00 p.m.** (As noted, the time of the meeting might be moved forward somewhat to avoid a scheduling conflict.) 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 final meeting of the year, to review the audited financial statements, was scheduled for **Wednesday, June 16, 2010 at 4:00 p.m**.

The meeting adjourned at 6:20 p.m.

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Secretary Chair

February 3, 2010

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