UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 96 OF THE AUDIT COMMITTEE

December 8, 2010

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, December 8, 2010 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 Penny Somerville
Mr. W. John Switzer
Mr. Chris Thatcher

Ms Catherine J. Riggall,
Vice-President, Business Affairs
Mr. Mark Britt, Director, Internal Audit
Ms Sheila Brown, Chief Financial Officer

Mr. Neil Dobbs, Secretary

Regrets:

Mr. J. Mark Gardhouse
Mr. Joseph Mapa

In Attendance:

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

ITEM 5 CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD FOR APPROVAL. ALL OTHER ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

1. Reports of the Previous Meetings

Report Number 94 (June 16, 2010) and Report Number 95 (September 15, 2010) were approved.

2. Business Arising from the Reports of the Previous Meetings

(a) Report Number 94, Item 5 – Audited Financial Statements for the Year Ended April 20, 2010

In response to a member's request for clarification, Ms Brown commented on the accounting for research grants held by members of the University's faculty within one of the

2. Business Arising from the Reports of the Previous Meetings (Cont'd)

(a) Report Number 94, Item 5 – Audited Financial Statements for the Year Ended April 20, 2010 (Cont'd)

affiliated teaching hospitals. Such grants were accounted for as income of the affiliated teaching hospital or its research institute and were not regarded as University income. It happened from time to time that reports on the broader research enterprise at the University included such grants in the income reported, leading to a larger number in such reports.

(b) Report Number 95, Item 3 – Review of Current Trends

The Chair reported that he had met with the Chair of the Governing Council to discuss certain matters that had arisen in the discussion of the Committee's role, particularly with respect to risk management. A follow-up meeting would take place.

3. Audit Committee Terms of Reference: Annual Review

The Chair recalled that the Committee had completed a detailed review and revision of its terms of reference four years ago. A further revision had been approved in June, arising from an arbitrator's decision to establish a Pension Committee. That revision required that the Audit Committee make its report and recommendation on the audited financial statements of the pension plans to the new Pension Committee rather than the Business Board. Because the Pension Committee had not yet been established, the Audit Committee would, for one final time this year, make its recommendation to the Business Board. There had been other suggestions for revisions to the terms of reference. One year ago, a member had suggested clarifying the Committee's role with respect to review of the control environment. At the Committee's special meeting in September, it had been decided that the Committee would give increased emphasis to risk management – devoting the whole of one meeting to the annual report on risk assessment and perhaps proposing a change in the Committee's name to emphasize the risk-management function.

Ms Riggall said that the Committee might wish to decide either to undertake a new examination of its terms of reference in the current year or alternatively to take into account the suggestions for changes during a substantive review on some future occasion.

A member suggested consideration of four other changes.

(a) Section 4, Function – External auditors' independence. The current terms of reference stated that the Committee "ensures the [external] auditors' independence in their relationships with the administration." The member said that while the Committee received reports from the external auditors, including their assurance of their independence, the accountability for their remaining independent was that of the auditors. The Chair suggested that the provision be amended to state that the Committee "reviews," "monitors," or "receives reports concerning" the auditors' independence.

3. Audit Committee Terms of Reference: Annual Review (Cont'd)

(b) Section 5.1.1(c) Responsibilities of the Committee: Financial reporting – Reports on outstanding legal actions against the University. The current terms of reference stated that the Committee "reviews, in connection with the review of the 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 the financial statements, as well as . . . to monitor possible risk exposures." The member was concerned that the adjective "substantial" might give the impression that there was a relatively high threshold for the actions that were to be disclosed to the Committee and reviewed. It was her impression that the report was a comprehensive one and that no action against the University, except perhaps very minor ones, would be excluded. Ms Brown said that the report disclosed all actions where the claim was for more than $300,000. Members agreed that the statement could read "an annual report on outstanding legal actions against the University in amounts over $300,000." That threshold could be reviewed and, if appropriate, adjusted in future years.

(c) Section 5.2, Responsibility of the administration – Preparation of financial statements. The terms of reference currently stated that the administration was directly responsible for "the University's risk-management and financial reporting processes, including . . . ." The member said that the provision should make it clear that the administration was responsible not only for the financial reporting process but also the product, i.e. the actual financial statements. Ms Brown noted that the administration signed an annual "Statement of Administrative Responsibility" acknowledging its responsibility with respect to the financial statements. A member noted that the first sub-item in the term of reference stated the administration's responsibility for "the preparation of financial reports and statements . . . ." Another member commented that while the terms of reference could make clearer the responsibility for preparation of the financial statements, they should continue to state the administration's responsibility for the process. The Chair suggested that the statement could be revised to read, "The administration is directly responsible for the University's financial reporting process, preparation of its financial statements, and its risk management process."

(d) Section 5.1.4(d), Financial controls and control environment – Whistle-blowing process. The current terms of reference stated that the Committee "reviews periodically the policies and processes for individual members of the University to draw to the attention of appropriate University officers, including the Director of the Internal Audit Department, any significant financial issues, problems, or irregularities. As part of that review, where reports are not anonymous, considers the adequacy of protections for members of the University who act to report significant financial issues, problems or irregularities. Reviews periodically reports on the operation of those policies and processes for reporting financial irregularities." The member observed that the Committee's calendar of business included no report on the operation of the whistle-blower policies and processes. The Committee should receive such a report to satisfy that responsibility in its terms of reference. Even if no actions had been taken by members of the University under the policy, that fact should be communicated in a nil report.

3. Audit Committee Terms of Reference: Annual Review (Cont'd)

Ms Riggall undertook to work with the committee Secretary to prepare a revised draft of the terms of reference, taking into account the suggestions that had been made at this meeting and previously. A member urged that the revised draft include revisions with respect to risk management, as discussed at the Committee's meeting on September 15. The revisions could be made in the light of the Chair's discussions with the Chair of the Governing Council or could be used to assist in advancing those discussions. The Chair observed that the issues with respect to risk management might prove to have implications that would affect more than the terms of reference of the Audit Committee. The member agreed, noting that it was important that responsibility for the matter be clearly located in the governance system. Another member agreed that there was need for a broader view. There was at present a conflict between the Committee's responsibility for reviewing "general risk exposure" (as stated in section 4 of its terms of reference) and what the Committee actually did. General risk exposure covered a much broader spectrum including such things as reputational risk.

The Chair said that the matter would again come before the Committee in the revised draft of the terms of reference.

4. Audit Committee Calendar of Business, 2010-11

The Chair said that the Calendar of Business showed the items planned to come before the Committee in the coming year. It was subject to change for a variety of reasons, including the emergence of new business. The current calendar of business was similar to that of the previous year, except for two changes, arising from the Committee's discussions in September. First, the March meeting date, previously a reserve date, would now be devoted to consideration of the annual risk-assessment report. Second, an *in camera* meeting with the Director of Internal Audit was on the Calendar for every meeting.

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010

Ms Brown presented the University of Toronto Pension Plans Annual Financial Report for the Year ended June 30, 2010. Among the highlights of her presentation were the following.

- **How a defined benefit plan works**. Pension plans built up liabilities for the amounts required to pay present and future pensioners and they built up funds of assets to meet those liabilities. Employees – the active members of the pension plan – earned pension credits for each year of service as members of the plan. The sum of those pension credits grew as active members added years of service and as new members joined the faculty and staff and became members of the pension plan. The net present value of those future obligations was calculated on the basis of actuarial assumptions and discounted to the present using a discount rate. That net present value was also reduced to reflect payments actually made to retired members. The outcome was the liability of the plan.

5. **Pension Plans: Annual Financial Report for the Year ended June 30, 2010** (Cont'd)

There were only two sources of funds to build up plan assets: (i) contributions to the pension plan by employees and by the University, and (ii) investment earnings. Those assets declined to reflect the cost of pensions paid to retired members and to reflect the cost of fees and expenses.

The difference in the amount of the liabilities and the market value of the assets represented the pension plan's market surplus or deficit.

- **Tools for the assessment of pensions**. Audited financial statements were prepared for the University's two registered plans: the main plan and the plan for the employees of the Ontario Institute for Studies in Education at the time of and prior to its merger with the University. The Committee would be asked later in the meeting to recommend to the Business Board approval of the financial statements for those plans, which provided an audit opinion on the fair value of their assets as at June 30, 2010.

  There were various methods for valuing the liabilities of the plans and therefore for determining their surpluses or (at this time) their deficits. The first was the going-concern actuarial valuation, which assumed that the plans would continue indefinitely. It compared each plan's going-concern liability at July 1, 2010 with the fair value of the assets as at June 30, 2010. The second was the solvency valuation. That valuation used the hypothesis that the plan had been wound up as at the valuation date. The liability was the cost of settling all pension obligations as at that date through the purchase of annuities or the making of lump-sum payments. According to regulation, the liability excluded the cost of indexation of benefits. That liability included hypothetical wind-up costs. The solvency liability was compared to the value of the assets. The third actuarial valuation was the wind-up valuation, which again used the hypothesis that the plan had been wound up as at the valuation date. In the case of the wind-up valuation, the liability included the cost of the plan's usual 75% indexation of benefits.

  In addition to the financial-statement treatment of the pension plans and the actuarial valuations, there was an accounting valuation of the plans in the University's financial statements. All of the assessments specifically related to the pension plans used the plan year, which ended on June 30. The accounting valuation related to the University's fiscal year, which ended on April 30. In addition, the accounting valuation used different rules.

  The principal focus of the University's attention was on the going-concern actuarial valuation of the plans, which compared the going-concern liabilities of the plans to both the fair value of the assets as at July 1, 2010 (market value) and to a smoothed valuation of the assets over a number of years (actuarial value). The University would also focus on the solvency valuation, when it became necessary to do so. It would almost certainly be necessary to do so for the next fiscal year when the solvency valuation would determine an amount of legally required funding.

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

- **Funding status of the plans**. Ms Brown reported the funding status of the combined pension plans: the two registered plans and the Supplemental Retirement Arrangement (S.R.A.) for those with salaries above the pensionable maximum as determined by the Income Tax Act. The report also took into account the University's Pension Reserve. There was a large going-concern market deficit amounting to $1,066-million, essentially unchanged from the previous year. The pension fund had earned an investment return of over 8% for the year, which exceeded the target investment return assumed in the valuation, but other factors, such as interest charges on the deficit, had resulted in a deficit that was essentially the same as the previous year.

  Ms Brown noted that the report at times showed the financial situation of the plans as a group, including the S.R.A. and the pension reserve. At times, the report focused on the individual plans. She stressed, however, that the registered plans were bound by regulations, and monies could not flow out of those plans. The funds set aside for the S.R.A. and the pension reserve were not bound by regulations, and funds could flow from them into the registered plans.

  The plans' liabilities had increased steadily over the past ten years. The funding status of the plans had largely reflected the economic cycles. In the year ended June 30, 2000, the plans had enjoyed a surplus of $579-million and in 2001 a surplus $284.2-million. As a result of the equities market retrenchment, that surplus had declined in 2002 and had become a deficit of $214-million in 2003. With an improving trend in the value of the assets between 2003 and 2007, the deficit had declined and had become a surplus of $225-million in 2007. That had, however, been followed by declines in asset values beginning in 2008, reflecting the impact of the financial crisis, and leading to the current severe deficit position.

- **Pension-plan liabilities**. The going-concern pension plan liability had grown inexorably over the past several years. By far the largest share of pension liabilities was on account of the main registered plan, with the OISE plan and the S.R.A representing only small portions of the overall liability. The number of participants in the main registered plan continued to increase. There had been no changes made in the past year in the benefits provided by the plans or in the assumptions used to estimate those benefits.

- **Liabilities: Actuarial assumptions**. The University was looking at a number of alternative assumptions, and the summary of the going-concern actuarial valuation showed the combined effect of three possible changes to the assumptions. The first was a possible reduction of 0.25% in the target rate of real investment return (i.e. the return after inflation) from 4% per year to 3.75% per year. The second change was a possible reduction in the assumed rate of inflation by 0.25% per year. Those changes together, should they occur, would reduce the nominal rate of investment return and therefore the discount rate by 0.5%. The third possible change would be a change to the mortality table projection to reflect the fact that pensioners were living longer. Any proposals for change would be taken to the new Pension Committee for consideration. The objective of the second column in the summary of the actuarial valuation was to provide a sensitivity analysis to show the effect of the possible changes in the assumptions.

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

- **Liabilities: Growth in plan membership**. A key driver in the growth of the plans' liabilities was the increase in the number of plan members – both active and retired members. The University's enrolment had grown by about 45% over the past decade, and that growth had led to the increase in faculty and staff to serve the increased enrolment and hence to the growth in the membership of the pension plan.

- **Pension-plan assets**. The value of the pension-plan assets, like the plans' surpluses and deficits, had moved up and down, predominantly reflecting the economic climate. In addition to the assets in the registered plans and in the fund set aside to meet the liability for the Supplemental Retirement Arrangement, the University had two years ago established the Pension Reserve fund. In addition to making pension-plan contributions for current service costs, the University had several years ago established a budget, now amounting to $27.2-million per year, for special pension-plan contributions. A portion of that had been paid into the pension plans and a portion had been set aside in the Reserve in anticipation of future payments into the plans.

  For the 2009-10 year, current-service contributions of nearly $110-million had been paid into the pension plans including $36.5-million from active members of the plan and the rest from the University. In addition, special payments of $27.6-million had been made by the University and either contributed to the plans or set aside in the Reserve for pensions. That amount included a small sum used to fund the Voluntary Early Academic Retirement Program.

  For the 2009-10 year, the investment return had been 8.2%, net of all fees and expenses.

  Assets had been reduced by payments to pensioners, which had amounted to $148.8-million in 2009-10 – an amount that was not substantially greater than the amount contributed to the plans. That was an important fact to consider. While the plans were, from a long-term point of view, in a serious deficit position, the actual cash flows out of the plans were at the present time nearly matched by inflows from contributions.

  Assets were also reduced by the amount of fees and expenses, which in 2009-10 had amounted to 1.17% of the value of the assets. That was a reduction of 0.3% from the 2008-09 year.

- **Assets: contributions**. Ms Brown displayed a graph showing contributions over the past ten years. In 2000-01, there had been no employee contributions and a very limited employer current-service contribution in the light of a contribution holiday. In 2001-02 there had been a partial holiday, with full employee contributions resuming in 2002-03 and full employer contributions resuming in 2003-04.

- **Assets: investment earnings**. Ms Brown displayed a graph showing investment earnings over the past twenty-one years. The University had established a target for investment earnings for the pension plan: a real return of 4% per year - i.e. the return after inflation and after all fees and expenses - over a ten-year period. That return was to be achieved within a risk corridor of one

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

standard deviation of 10% from the target, again over ten years. That meant that the University should expect that real returns would be between 14% and -6% two thirds of the time over a ten-year period. The one-year return had been within the expected corridor for 16 of those 21 years, or 76% of the time. They had been outside of the corridor for five years or 24% of the time – two years above and three years below.

Over the full period, the actual average return of 6.1% per year had matched exactly the University's target return of 6.1%, taking into account the 27.6% investment loss in 2008-09. Over the period since 1990, actual returns have exactly met the University target return of CPI + 4%. Looking at ten-year rolling returns since 1990 (appropriate because the targets were ten-year targets), the average actual return had been slightly above the target until 2007, then falling slightly below. The ten-year average return had remained within the risk corridor in all years except for 2008-09 and 2009-10.

Ms Brown displayed graphs showing the effects of a possible reduction in the investment return target, noting that some members of the University had expressed their view that a reduced return target, and therefore a less risky pension fund investment portfolio, would be appropriate. If the University were to reduce its target real return by one quarter of one percent to 3.75%, then current service contributions to the main pension plan would have to increase by $6-million to $121-million per year for 2010-11. The main pension-plan deficit as at July 1, 2010 would grow by almost $104-million to $1,136-million. If it were to reduce its real-return target to 2% per year, then current service contributions would have to increase by a further $60-million per year to $181-million for 2010-11. With the target reduced to 2%, the market deficit in the plan as at July 1, 2010 would increase to $2,065 million. Mr. Shapira noted that the graphs showed how much any pension plan depended on investment returns. If returns were lower, as they had been in 2008-09, the plan sponsor had to make up for the decline in assets in other ways. Ms Brown said that this information was intended to help to frame the future discussion about appropriate investment-return targets.

- **Pension payments**. Pension payments had been growing steadily over the past decade as more members of the faculty and staff retired and as, with the passage of time, their highest-36-month average salaries (upon which pension payments were partly based) had increased. Over the decade, payments from the three plans had grown by $72-million to $149-million in 2009-10.

- **Fees and expenses** had grown over the decade until 2009-10. The significant increases from 2007 to 2009 had largely reflected the growth in investment categories – the alternative investment strategies - with higher fees. Similarly, the decline in fees and expenses in 2010 reflected the reduced external investment-management fees as the use of alternative strategies had declined. The changes in the percentage cost of fees had also reflected the amount of the assets in the pension fund – the denominator of the fraction of fees and expenses as a proportion of total assets. The increase from the proportion from 1.04% in 2007-08 to 1.47% in 2008-09 had

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

reflected the reduction in the size of the pension fund because of the financial crisis, and the reduction of fees and expenses to 1.17% in 2010 had in part reflected the growth in the size of the pension fund – the denominator of the fraction.

- **History of market surpluses and deficits**. The main registered pension plan had enjoyed a market surplus of $579-million for the year ended June 30, 2000. That surplus had declined over the next two years and had become a deficit of $203-million for the year ended June 30, 2003. The size of the deficit had then diminished for the three following years, and the plan had then enjoyed a surplus of $184-million in 2007. With the financial crisis beginning in 2008, the plan had once again fallen into a deficit and had a deficit of 1,032-million as at the 2010 valuation.

  The solvency ratio of a plan compared the value of the liabilities, calculated using a market rate of interest assumption, to the fair value of its assets. It excluded the cost of the partial indexing of pensions and included a provision for wind-up costs. Where the solvency ratio was 1.0 or greater, the plan met the solvency test. Where the solvency ratio was less than 1.0, there was a solvency deficit. The main registered plan had met the solvency test up to and including 2007, but beginning in 2008 the solvency ratio had declined to a level below 1.0. The ratio was 0.98 in 2008 and had declined to 0.64 by 2010.

- **Investment return update**. The pension fund's actual investment return for the year ended June 30, 2010 had been 8.2%. Returns had been very poor in the last two months of that period, which had unfortunate consequences for the annual valuation. However, markets had rebounded significantly since June 30, with the pension fund (according to preliminary figures) earning a return of 6.7% in the four months from July 1 to October 31, 2010.

- **Dealing with the pension-plan solvency deficit**. The going-concern market deficit of $1.03-billion in the main registered plan was required by regulation to be funded over a fifteen-year period However, since there was also a solvency deficiency, Ontario regulation would normally require accelerated funding over a five-year period.

  In response to a question, Mr. Shapira said that the solvency valuation hypothesized that the plan had been wound up on the valuation date, and that the University would have to settle its obligations to members of the plan either through lump-sum payments or through the purchase of annuities. The cost of annuities, or the one-time cost of a lump-sum payment, depended on the interest rate in effect at the time. That interest rate was the Government of Canada bond rate plus a small premium. With a very low interest rate to generate payments to meet the pension promise, the cost of annuities would be very high. In terms of the solvency test, the decline in interest rates had as great a negative effect as the sharp decline in the securities markets in 2008.

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

Ms Brown said that the University would be required to file its pension-plan valuations as at July 1, 2011. The administration assumed that the plans would continue to have large deficits in both going-concern and solvency terms. The administration was, therefore, considering a plan to deal with the matter.

The Government of Ontario had proposed legislation to make some temporary solvency funding relief available to institutions in the broader public sector. In the absence of such relief, the University would be required to pay down its solvency deficit with special payments, in addition to current service payments, over a period of five years. That would require annual payments of just over $200-million in addition to the $70-million current service cost – a requirement that would be catastrophic.

The Government of Ontario had recently set out expectations for the steps that should be taken for each University's plan to be considered sustainable. The resulting pending regulation would put in place a two-stage process that was intended to provide institutions in the broader public sector, including universities, with an opportunity to make net solvency payments over a longer period than would otherwise be required

To enter the first stage of the proposed relief program, institutions would be required to develop and present a plan to make their pension plans sustainable. Measures in such a plan might include an increase in active members' contributions toward the current service cost of the plan, reducing the share to be paid by the public-sector institutions and ultimately by the taxpayers. Measures might also include movement to a jointly sponsored plan where plan members would share the risk of the plan with the public-sector employer. They might include a reduction in future benefits and hence the cost of the plan. The University of Toronto would be required to present its plan along with its next required actuarial valuation – that for the year ending June 30, 2011. The Government would review the plan to determine whether it met the technical tests for the program, which had not yet been announced. If the University's plan was accepted, the University would enter Stage 1, which would last for three years. In those three years, it would be required to make, in addition to current-service payments, special payments at least equal to the amount that would be required to pay off its going-concern deficit over fifteen years.

If then the University was permitted to enter Stage 2, it would be required to pay, in addition to current service costs, special payments to eliminate its solvency deficit over the next ten years, i.e. until 2024.

During all stages of the solvency-relief program, there would be restrictions placed on the plans that would, among other things, require accelerated funding of any benefit improvements.

In response to a question, Mr. Shapira said that it was still unclear whether the Government would require a highly specific plan for an institution to enter Stage 1 or whether it would require

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

only a statement of intention. It was clear that institutions would not be required to have achieved implementation of their plans to enter Stage 1.

- **Options for addressing the issue**. Ms Brown recalled that there were only two ways to fund the pension plans: contributions and investment earnings. The University had no plan to rely on increasing investment earnings by increasing its investment-return target. Therefore the options for addressing the pension-plan deficit would focus on increasing the University's contributions. Ms Brown outlined the possibilities under consideration.

  One possibility, which would no doubt be adopted, would be to transfer the balance of the Pension Reserve into the registered plans. That reserve, established in 2009, was expected to be $37.3-million on June 30, 2011.

  Another possibility was to transfer the assets set aside to meet the University's obligations under the Supplemental Retirement Arrangement (S.R.A.) into the registered plans. The S.R.A. was an unregistered pension plan established in 1997 to provide for pensions relating to salaries above the *Income Tax Act* pensionable maximum, which was at the time approximately $100,000 per year, to a maximum salary of $150,000 per year. The University had decided to build up assets to meet its obligations under the S.R.A. and had been doing so since 1997. Those assets totaled $115.8-million as at June 30, 2010. In recent years, the maximum pensionable salary under the *Income Tax Act* had been increased, and it was currently about $134,000 per year. It was anticipated that the *Income Tax Act* maximum would in about three years' time reach the $150,000 limit of the S.R.A. At that time, all new pension entitlements previously covered under the S.R.A. would be covered under the regular registered plans, and the S.R.A. would be closed. There would then be no need to continue to set aside assets to deal with new obligations under the S.R.A. The assets set aside to date were not required to be reserved; they were not in a trust fund. Rather, the assets were commingled with other University assets and, as was made clear each year in the financial statements, were legally available to satisfy any action undertaken by the University's creditors, and they were not directly available to members of the S.R.A. If the assets set aside for the S.R.A. were used instead for the registered plans, the University would have to make payments to retired members of the S.R.A. from regular revenues. Such payments would initially require about $10-million per year. Because the University was an on-going institution, members of the S.R.A. would need to have no concern that their pensions were secure. It was possible that the University could at some future time develop a plan again to build up assets to match its obligations under the S.R.A., but in the circumstances, it might well be deemed unnecessary to do so.

  If the possibility of transfer of the S.R.A. assets into the registered plan was to be adopted and if the pension reserve was to be transferred into the registered pension plans, the outcome was anticipated to be a reduction in the solvency deficit of some $160-million. The deficit would in the normal course also be reduced by the budgeted annual special contribution, although the

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

budget would also have to take into account the amount, initially about $10-million per year, required to pay pensions under the S.R.A.

Underpinning the strategy would likely be an increase in the level of member contributions to the pension plan. While such contributions could be directed only to meeting the current-service cost of the plan and would not be in respect of special solvency payments, increased member contributions were very likely to be required by the Government for the University to be permitted to avail itself of the planned temporary solvency-funding relief program.

Another possibility was an increase to the University's budget for special contributions to the pension plans, currently about $27-million per year.

Another possibility was borrowing, either internally from the Expendable Funds Investment Pool, or externally. The borrowed funds would form a special contribution(s) to the registered plans. Such borrowing would, of course, have to be repaid over time with interest, but it could be repaid on a schedule extending longer than that for solvency payments. There would, if the University were to borrow for this purpose, be need to budget for blended principal and interest payments over the term of the loan.

Another possibility, which was set out in the pending legislation, would be the issue of irrevocable letters of credit in respect of solvency funding requirements to a maximum of 15 % of the solvency liabilities. This could prove to be an important tool to deal with the volatility of the pension fund's investment returns, which would always vary from year to year from the assumed return. In the event that the return in any given year was less that that assumed in the actuarial valuation, a letter of credit would permit dealing with the shortfall without the need to find a potentially large amount of cash.

Finally, the University could sell assets, contributing the proceeds to the registered pension plans.

Ms Brown stressed that that *Pension Benefits Act* would not permit a possibility that had been suggested by some people - assigning other assets to the ownership of the pension fund.

Ms Brown stated that all of the options were being examined and modeled as components of a viable pension funding strategy, which would be presented to the Business Board at its meeting of January 31, 2011. It would, however, likely be necessary to revise the strategy somewhat in the light of the actuarial valuation as at July 1, 2011.

- **Current uncertainties**. There were a number of uncertainties concerning the financial planning for funding the pension plans. First, the regulation concerning the public-sector temporary solvency-funding relief program had not yet been released. Second, the University, through its new Pension Committee, had not yet established the investment-return target and volatility-tolerance limit for the pension fund. Third, the actuarial assumptions for the plans remained

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

under review. Fourth, there was no certainty that the University's plan would be accepted for the stage 1, and if so for stage 2, of the temporary solvency funding relief program. Fourth, there was always uncertainty concerning the overall economic climate, the performance of the securities markets, and interest rates. Those factors would have an enormous impact on the financial status of the pension plans.

Invited to comment, Mr. Shapira said that pension-plan deficits represented a serious problem across the University sector in Canada. The University of Toronto was far from unique. The quantum of the deficits and the ability of institutions to deal with them did vary. The problem existed in fact across the broader public sector. Solutions would be difficult and require very painful trade-offs. As with any debt, pension deficits accumulated interest and the problem would continue to grow until it was addressed.

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

(a) Government response to a proposed solvency-funding-relief plan. A member observed that, given the catastrophic consequences of the Government's not permitting any institution to participate in the temporary solvency relief program, it would be politically very difficult for the Government to refuse to do so. Ms Brown said that the University was certainly making every effort to advocate the case for solvency relief.

(b) Complexity of achieving a solvency-funding-relief plan. A member observed that it would be very complex for the University to implement any elements of a plan that would require the agreement of the Faculty Association and ten union groups. Mr. Shapira observed that there were probably about 70 bargaining units across the Province's university sector.

(c) Effect of the end of mandatory retirement. In response to a member's question, Mr. Shapira said that the end of mandatory retirement at age 65 had already been built into the valuation of the plan liabilities. The valuation assumed that some plan members would take early retirements, some would arrange a phased retirement, and others would retire later. There was likely to be no financial benefit arising from the end of mandatory retirement, however. While plan members might well work longer and require pension payments for fewer years, their average lifespan was also increasing. He noted that the *Income Tax Act* required that plans commence payments to pension-plan members at the end of the year in which they turned age 71, even if they were still working.

(d) Cost of external borrowing. In response to a question, Ms Brown said that the cost of external borrowing would depend on market conditions at the time. At the time of the issue of its first debenture, the University's borrowing cost was 75 basis points above that of Government of Canada bonds for comparable terms. For the more recent debentures, the spread had narrowed to about 60 basis points. However, the financial crisis had negatively impacted spreads, and it was unlikely that the University would be able to obtain such favourable spreads at this time.

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

However, no University in Canada had borrowed money in the recent past, with the result that it was difficult to predict what that spread might be.

(e) Contribution holidays. In response to a question, Ms Brown said that the University and active members of the pension plans had enjoyed pension holidays some years ago as the result of a regulation under the *Income Tax Act* that prohibited employer contributions to a plan when its surplus exceeded 10% of its liability. That provision had recently been amended to permit contributions until a surplus exceeded 25% of the liability.

(f) Provincial view on jointly-sponsored pension plans. In response to a member's question, Ms Riggall said that the Province of Ontario had asked universities to consider the possibility of jointly sponsored plans in which management risk, deficits and surpluses would be shared equally by the universities and their employees. The Government had also asked for consideration of the possibility of formation of a multi-employer plan. Mr. Shapira noted that the Government's thinking was influenced by the fact that the large public-sector plans in Ontario were joint plans, including the Ontario Teachers' Pension Plan and the Ontario Municipal Employee's Retirement System (OMERS). Alberta's universities also participated in a jointly sponsored plan. In those cases, both employers and employees contributed 10% - 11% of salaries to the plans. Mr. Shapira anticipated that securing agreement to the idea would be difficult. He noted that the idea of jointly sponsored plans had also been supported by Ontario's Expert Committee on Pensions.

(g) Possibility of a switch to a defined-contribution plan. A member noted that in the private sector, many employers were "grand-parenting" current employees in defined-benefit plans but were providing defined-contribution plans for new employees. That change was being forced on employers by financial conditions. The member asked whether such a change was being considered in the broader public sector in Ontario. Mr. Shapira replied that while a few universities had money-purchase plans or elements of money-purchase plans, sometimes with minimum guarantees, in the broader public sector, defined-benefit plans remained the rule. That might in part be the case because employees in universities, hospitals and other public-sector institutions tended to remain with the same employer throughout their careers. The option of a financially secure retirement often served to encourage employees to retire at the usual retirement age, enabling employers to renew their workforces. That was a less significant factor in the private sector, where employees tended to move more frequently among employers.

(h) Investment return. A member observed that, as at June 30, 2010, the one-year return for the pension master trust had been 8.2%. He asked whether the administration was comfortable with the investment of the fund. Ms Riggall replied that the investment return had been a function of the asset allocation of the fund. The public markets – equities and fixed income – had recovered, and the fund's performance in those categories had been satisfactory. The problem in 2009-10 had been the allocation to alternative asset categories. The new Investment Advisory Committee had been considering whether it would be appropriate for the fund to

5. Pension Plans: Annual Financial Report for the Year ended June 30, 2010 (Cont'd)

continue with its current complex portfolio or whether it should simplify the portfolio to reduce investments in the alternative categories, in particular private investments. The general view was that the allocation to private investments should be reduced substantially, but only at the end of the terms of the investments in the current private funds. It would be possible to sell the fund's investments at reasonable valuations in only the best funds, leaving the pension master trust with only the poorest performing funds. The Committee had therefore reached the conclusion that the pension fund would probably be best advised to retain the private investments for their terms. It was anticipated that the overall portfolio of private investments would generate a positive cash flow in the next year.

Invited to comment on the audited financial statements for the two registered plans, Ms Tory referred members to Ernst & Young's letter to the Committee dated November 19, 2010. The auditors had, as usual, received excellent co-operation from management. The auditors' letter consisted largely of required communications; there were no non-routine matters for the auditors to draw to the attention of the Committee. The letter did advise of one change in accounting principles, contained in section 4600 of the Canadian Institute of Chartered Accountants *Handbook*, "Pension Plans," that would bear on the next year's financial statements. The plans' liability would be shown on the balance sheet of the statements, which presently showed only the net assets available for benefits. That would make clear the surplus or deficit in the plans. The information on the plans' liability (the "obligation for pension benefits") was currently contained only in the notes to the financial statements.

On the recommendation of the Vice-President, Business Affairs

YOUR COMMITTEE RECOMMENDS

(a) THAT the audited financial statements for the University of Toronto Pension Plan, June 30, 2010, be approved, and

(b) THAT the audited financial statements for the University of Toronto (OISE) Pension Plan, June 30, 2010, be approved.

6. External Auditors: Engagement Letter, Audit Plans, Report on Accounting Developments and Audit Fees

Ms Tory said that the planned approach to the audit of the University's financial statements had not changed in any significant way from the previous year. The University was reasonably consistent in what it did and how it went about doing it, and there were no unusual changes in the risk it faced. Ms Tory asked the Committee to identify any areas: (a) where it thought that a different approach would be appropriate, and (b) where it thought the auditors should be particularly sensitive in the 2011 audit.

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

Ms Tory referred to pages 6 and 7 of the Ernst & Young Report on Audit Planning for the Year Ending 30 April 2011, which reported five areas of audit significance that had been discussed with management. Those items were ones in which the auditors would update their understanding of matters that had arisen in the previous year. There were no matters of substantial significance that had arisen more recently. In all cases, management had completed research on the matters and had shared the outcome with the auditors. Ms Tory was confident that all issues would be resolved before the beginning of the audit.

Ms Tory reported that there was substantial continuity in the audit team for the 2011 audit. One new person, Ms Ann Duggan, would serve as Audit Senior Manager, providing senior level backup to Ms Tory and Ms Cheung.

Ms Tory referred members to the fee proposal on pages 18 and 19 of the Report. In recognition of the University's financial constraints, Ernst & Young was proposing no increase in the $129,500 fee for the main University audit. There would be need for some increase in the fee for smaller audits of particular grants, driven by an increase in the number of audits required by the Government grantors. For example, there was a requirement for an audit of a $100,000 grant, with a $1,000 level of materiality, therefore requiring review of many small disbursements. The level of materiality for the main University audit was, on the other hand, $15-million. While there were some discussions underway with the Government, the requirement for the audits was beyond the control of the University or the auditors.

In response to members' questions, Ms Tory said that the new accounting rules would apply to the University's financial statements for the year ending April 30, 2013. The new International Financial Reporting Standards would not be applied by most not-for-profit organizations in the private sector. Rather, most would use standards in part like those applicable for private enterprises supplemented by not-for-profit specific directives. The new rules were expected to be issued in December, 2010. Ms Tory was, on behalf of Ernst & Young, preparing detailed presentations on the new accounting rules, and members would be welcome to attend. She would also be pleased to provide a briefer presentation to a future Committee meeting.

A member observed, on the Supplementary Schedule of Fees, that Ernst & Young had provided substantial advice to the University with respect to sales taxes. Mr. Piché said that the University had, on the basis of that advice, been successful in obtaining exemptions from, or rebates for, a substantial amount of sales taxes.

6. External Auditors: Engagement Letter, Audit Plans, Report on Accounting Developments and Audit Fees

On motion duly made and seconded and carried

YOUR COMMITTEE RESOLVED

THAT the Audit Committee accept the external auditors' engagement letter for the year ended April 30, 2011, as outlined in the report from Ernst & Young dated December 1, 2010.

7. Administrative Accountability Reports: Annual Report on the Program, 2009-10

Mr. Piché presented for information the annual report on the program of administrative accountability reports prepared by all faculty and staff with financial responsibilities for 2009-10. All members of the senior executive group who reported to the President had completed reports, which had been reviewed by the President, and the President's report was attached to the report to the Committee. There had been no negative responses. All accountability reports made by academic administrators had been submitted to their Principals and Deans and to the Vice-President and Provost. There had been only one negative response out of the 350 reports submitted.

8. Internal Audit Department: Semi-Annual Activity Report for the Six Months Ended October 31, 2010

Mr. Britt presented the Internal Audit Department activity report for the first six months of the 2010-11 fiscal year. He was pleased to report that the Internal Audit staff complement had remained consistent throughout the period. The staff had, based on their growing experience, been able to address well the challenges assigned to them. The Department had delivered 4,400 audit hours, representing about 56% of the hours included in the annual plan. That had been the case notwithstanding the loss of 250 hours to a staff member's illness. Other staff members had provided substantial overtime work to achieve that result. The Department had completed departmental audits and follow-up reviews (42% of its time) and had completed the continuous audit program (12% of its time). One aspect of the Department's work merited special mention. 31% of audit hours during the period had been devoted to special reviews. That commitment of time had been required for two very time-consuming special reviews. In one case, the matter had been resolved; in a second case, the review was continuing and providing real challenges.

Mr. Britt reported on the outcome of the departmental, follow-up and continuous auditing, which had shown no unmitigated financial or operational risks. There had been some reduction in the frequency and seriousness of items requiring attention as the result of the continuous audits. The primary deficiency had been the absence of appropriate supporting documentation for disbursements, which the Internal Audit Department regarded as a less serious

8. Internal Audit Department: Semi-Annual Activity Report for the Six Months Ended October 31, 2010 (Cont'd)

problem than the absence of appropriate approval of such disbursements. There had been no instances of lack of appropriate approval.

Mr. Britt reported that the Department had allocated 14% of its hours in the period to providing assistance to the external auditors in their completion of the annual audit of the University's financial statements, its enrolment report, its capital projects, and one specific program. That allocation of hours had been provided for many years, and it reduced the University's cost for its external audit.

Mr. Britt reported that he had encouraged his staff to participate in various University working groups and committees dealing with such matters as business continuity planning, risk management, information-system governance, and compliance with respect to the use of payment cards. The opportunity to provide advice on control issues and other relevant matters at an early stage prevented having to deal with problems at a later time.

A member, noting that the Department had in the first half of the year, provided 56% of its audit hours, asked whether there was seasonality to the Department's work. Mr. Britt replied that because of summer vacations, the Department typically provided less than 50% of its planned hours in the first half of the year. That had not been the case in the current year, with staff members deferring vacations and providing overtime hours to deal with the time-consuming special audits and well as to deal with the regular audit plan.

9. Report of the Administration

Ms Riggall, Ms Brown, Mr. Britt and Mr. Piché said that they knew of no other matters that should be drawn to the attention of the Audit Committee.

10. Date of Next Meeting

The Chair reminded members that the next regular meeting was scheduled for Monday, March 21, 2011 at 4:00 p.m. That meeting would consider the annual risk-assessment report

THE COMMITTEE MOVED *IN CAMERA*.

11. *In Camera* Meeting with the Internal Auditor

The administrative assessors other than Mr. Britt absented themselves, and the Chair invited Mr. Britt to comment on any matters that should be drawn to the Committee's attention and to respond to any questions.

THE COMMITTEE COMPLETED *ITS IN CAMERA* SESSION.

The meeting adjourned at 6:05 p.m.

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Secretary	Chair

February 28, 2011

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