UNIVERSITY OF
TORONTO

Impact of new accounting rules on the April 30, 2013 financial statements

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Executive Summary

The purpose of this report is to summarize the impact of implementing the Canadian Institute of Chartered Accountants' (CICA) new Not-for-Profit Accounting guidelines (Part III) on the University of Toronto (U of T) financial statements. This report focuses on the key changes of the new section which impact the University, namely employee future benefits, valuing capital assets at fair value and measuring financial instruments. These issues are analyzed from the perspective of U of T's financial statements, and for the comparability and consistency between U of T's financial statements and the financial statements of its pension plans. Where policy choices are available, this report presents the pros and cons of each option. A summary of other impacts which are not as significant, but nonetheless important, are considered at the end of this report. We have settled on the following:

1. **Employee Future Benefits** – apply the immediate recognition approach for all the University's defined benefit plans and measure the obligations using funding assumptions. The result of changing from accounting assumptions to funding assumptions would be an increase in net assets at the date of transition by approximately $350 million. The University has unamortized net actuarial losses of $1,268.9 million, unamortized past service costs of $74.7 million, and unamortized transitional assets of $67.2 million using accounting assumptions to will need to be recognized in net assets. The result of changing to the immediate recognition approach would be a reduction in net assets at the date of transition (May 1, 2011) of $1,276.4 million ($1,268.9 + $74.7 - $67.2). The net result of the above changes would be a decrease in net assets of approximately $926 million ($1,276.4 - $350).

2. **Capital Assets** – value U of T lands at fair value, using a certified appraisal acceptable to our external auditors. The land is currently recorded at $76.6 million and has been appraised at $2,161.6 million which results in a net increase in net assets of $2,085 million ($2,161.6 - $76.6).

3. **Financial Assets and Financial Liabilities** – elect to measure equities not publicly traded and other financial assets, including fixed income and all derivatives at fair value. Closing prices are required to be used instead of bid prices for bonds and publicly traded equities which results in an increase in net assets of $1.1 million.

The net impact of the above selections on the financial statements for the year ended April 30, 2013 is a net increase in net assets at the date of transition of approximately $1.2 billion. (See Appendix A). The selections have no impact on the University's cash flows.

Overview of CICA Part III

Similar to other Ontario universities (and non-government-controlled universities in other provinces), the University has decided to apply Part III of the CICA Handbook effective for years beginning January 1, 2012 which, for U of T, will be the fiscal year ending April 30, 2013. While the CICA allows private sector not-for-profit organizations to voluntarily adopt full International Financial Reporting Standards (IFRS), this option has been rejected by universities across Canada as it prevents organizations from turning to Part III of the CICA Handbook for guidance for dealing with issues specific to not-for-profit organizations which are not addressed by IFRS. These international standards also require extensive disclosures that would not be meaningful to not-for-profit organizations. This conclusion is supported and recommended by our external auditors.

As required, U of T will begin applying Part III of the CICA Handbook retrospectively, meaning that the comparative financial information for the year ended April 30, 2012 will be prepared as if the accounting standards for Part III were always in place. Any adjustments due to the retrospective or transitional application of any new accounting rules will be recorded as at May 1, 2011. This date is relevant because, while the restatement will occur in our April 30, 2013 financial statements (which include comparative financial statements at April 30, 2012), the restatement is assumed to take place on the first day of the comparative fiscal year, which is May 1, 2011.

For topics not specifically included in Part III of the CICA Handbook, the University must apply the standards of Part II of the CICA Handbook (Accounting Standards for Private Enterprises) to the extent that the Part II standards address topics not addressed in Part III.

It is important to look at the options available for U of T's financial statements because of the impact that certain choices will have on the balance sheet, statement of operations, statement of changes in net assets. In addition, these choices may have implications on future self-determined debt limits, and will impact the comparability of financial statements with other Ontario and Canadian universities.

This paper will focus on two major decisions that must be made for the April 30, 2013 financial statements: (1) implementing the employee future benefits section of Part II of the CICA Handbook; and, (2) deciding if U of T will apply the transitional provision of Part III which permits capital assets to be valued at fair market value.

Basic Principles

When analyzing the various policy choices, the following principles were used to guide the selections. It is recognized that some of these principles are at odds with each other.

- consistency of accounting for pension obligations between the U of T financial statements and the financial statements of its pension plans,
- stability and predictability of net income on the statement of operations in U of T's financial statements,
- comparability with other Ontario and Canadian universities,
- the simplification of accounting for employee future benefits, and
- minimization of possible cost and administrative burden to the University.

Employee Future Benefits

Current Accounting Practice

The following is a summary of current accounting practice for pension plans, other retirement plans and post-employment benefits at U of T:

- Cost of plans related to employees' current service is charged to income annually, computed on an actuarial basis using the projected benefits prorated on service method.
- Actuarial gains and losses, past service costs arising from plan amendments and transitional assets/obligations are amortized over the average remaining service life of active employees (deferral and amortization approach).
- Liabilities are discounted using current interest rates on long-term corporate bonds (i.e. accounting assumptions are used).

Policy Choices

The policy choices available relating to employee future benefits under the new standards are shown graphically on the next page and are as follows:

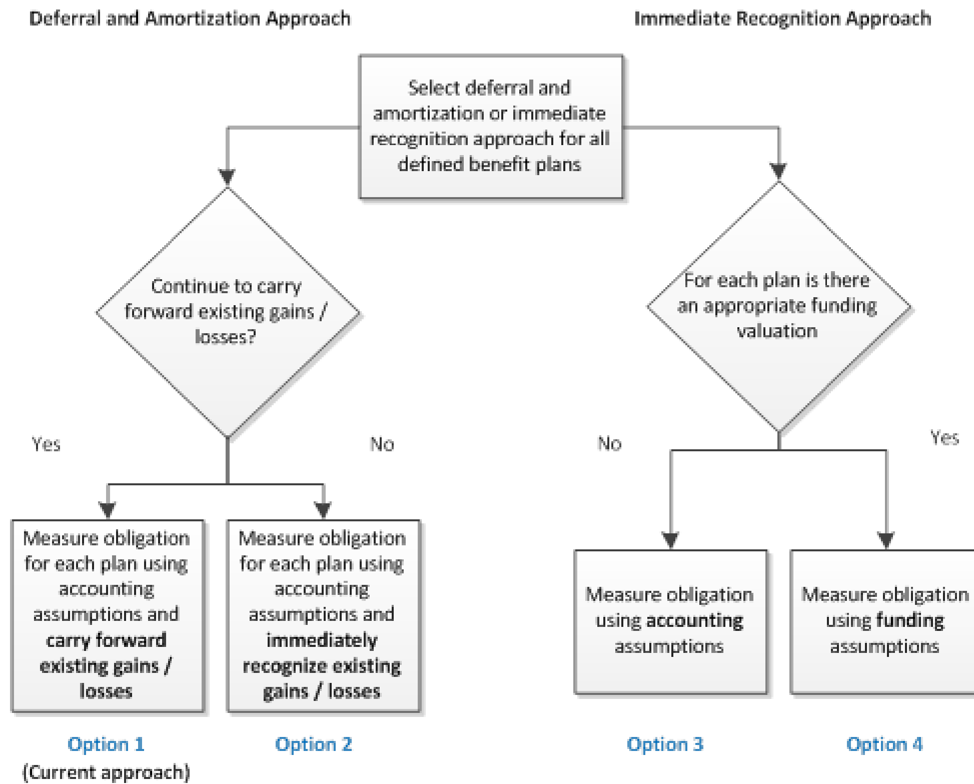
- Select the immediate recognition approach OR keep our current policy which uses the deferral and amortization approach for ALL defined benefit plans

- If the deferral and amortization approach is used, continue our current approach and measure the obligation using accounting assumptions but have the choice to either continue to carry forward unrecognized actuarial gains and losses and past service costs that were determined previously under the current rules OR elect to recognize all accumulated actuarial gains and losses and past service costs in the opening net assets at the date of transition (i.e. the opening net assets as of May 1, 2011)

- If the immediate recognition approach is used, select funding assumptions OR accounting assumptions for measuring the obligation and immediately recognize, at the date of transition, all accumulated actuarial gains and losses and past service costs in the opening net assets.

Under both approaches, all unamortized transitional assets ($67.2 million) must be recognized as an increase in net assets.

The following chart shows the policy choices in graphical form:



Options

The University has four distinct options for its financial statements. The following summarizes the options and shows the advantages and disadvantages of each option:

Option 1 (current approach)

Continue to use the *deferral and amortization* approach: measure the obligation for each plan using *accounting assumptions*, carry forward current unrecognized actuarial gains and losses and past service costs that were determined previously based on current accounting guidelines and amortized over the average remaining service life of active employees.

Advantages:

a) users of U of T financial statements are already familiar with this approach, and

b) deferral and amortization spreads the impact of actuarial changes over a longer period of time, i.e. approximately 14 years, which lessens the impact on pension expense in the statement of operations from year to year.

Disadvantages:

a) continued confusion since the valuation of the pension obligation for the University financial statements (accounting assumptions using current long-term corporate bond rates) is done on a different basis than for the pension plan financial statements as well as for the valuation provided for governance and regulators (funding assumptions using a discount rate representing the long-term investment returns anticipated for the plans),

b) the use of current long-term corporate bond rates can result in large fluctuations in the pension obligation from year to year during a period of volatile changes in interest rates, and

c) it is highly likely that future accounting standards will require immediate recognition of actuarial gains and losses, creating a reduction in net assets in a future year when the impact of this change could be mitigated now by adopting the transitional provisions which allow for the increase in fair value of capital assets.

Option 2

Use the *deferral and amortization* approach: measure the obligation for each plan using *accounting assumptions,* and, unlike option 1 above, elect to recognize all accumulated actuarial gains and losses and past service costs in the opening retained earnings at the date of transition (i.e. the opening retained earnings as of May 1, 2011).

Advantages:

a) users of U of T financial statements are already familiar with this approach, and

b) similar to (b) in option 1 except will spread any FUTURE actuarial gains and losses over approximately 14 years, which lessens the impact on pension expense in the statement of operations from year to year, and

c) by recognizing previously deferred actuarial gains and losses, future pension expenses will be lower since the University has large unamortized actuarial losses that would no longer flow through the statement of operations,

d) electing to recognize previously unamortized net actuarial losses and past service costs in opening retained earnings at the date of transition would allow the University to offset the impact on opening net assets against the increase in proposed fair value of capital assets.

Disadvantages:

Same as (a) and (b) in option 1

Option 3

Use the *immediate recognition approach*, measuring the obligation using *accounting assumptions*. With the immediate recognition approach, all accumulated actuarial gains and losses and past service costs are recognized in the opening net assets at the date of transition (i.e. the opening net assets as of May 1, 2011) irrespective of the valuation method used.

Advantages:

a) the immediate recognition approach provides more transparency to the pension status by including what were previously the "unamortized" components in the accrued pension liability on the balance sheet. As a result, the accrued pension liability more closely represents the funded status of the pension plan,

b) recognizing unamortized actuarial losses and past service costs in the net assets could be offset by adopting the transitional provisions which allow for the increase to the fair value of capital assets. This is a one-time opportunity to recognize these unamortized amounts without resulting in a large reduction in net assets,

c) both International and Canadian accounting standards appear to be moving quickly towards the requirement that only the immediate recognition approach be used in the future. Adoption of this approach now would mean that the University would avoid another accounting change in a few years, and

d) accounting assumptions are currently used, so some users may feel more comfortable continuing with that method.

Disadvantages:

a) the immediate recognition approach can result in large swings in net income (pension expense) from year to year as a result of actuarial experience, changes in assumptions and changes to plan benefits (similar to option 4), and

b) the continued use of accounting assumptions would mean that the valuation of the pension obligation for the University's financial statements and the valuation for governance and regulators would continue to be very different.

Option 4

Use the *immediate recognition approach*, measuring the obligation using *funding assumptions*. With the immediate recognition approach, all accumulated actuarial gains and losses and past service costs are recognized in the opening net assets at the date of transition (i.e. the opening net assets of May 1, 2011) irrespective of the valuation method used.

Advantages:

Same advantages as (a), (b), (c) and (d) in option 3, and

a) measuring the pension obligation using funding assumptions would provide more comparability and consistency between the University financial statements, the pension plan financial statements and the going concern obligation provided to University governance and to regulators.

Disadvantages:

a) the immediate recognition approach can result in larger swings in net income (pension expense) from year to year as a result of actuarial experience, changes in assumptions and changes to plan benefits (similar to option 3).

Other considerations

Future direction of standards

As noted in option 3 above, the Accounting Standards Board (AcSB) has recently issued an exposure draft that would replace Section 3461 (*Employee Future Benefits*) with a new Section 3462. This new section, if accepted by the AcSB after broad consultation, would eliminate the deferral and amortization approach option for private enterprises and not-for-profit organizations for all fiscal years beginning on January 1, 2014 (Fiscal year ended April 30, 2015 for the University of Toronto). The thinking behind this change is that the immediate recognition approach, which ensures that the defined benefit liability (defined benefit obligation net of plan assets) is fully recorded on the balance sheet and that all changes from re-measuring these amounts are recognized in income as they arise is favoured by lenders.

In addition, the international accounting standard *Accounting for Employee Benefits (IAS 19)* is moving to immediate recognition of all changes in plan assets and liabilities starting in periods on or after Jan 1, 2013. Therefore, an increasing number of financial statement users will be more comfortable with the immediate recognition approach in the future.

Comparability and consistency between financial statements of the Pension Plans and those of the University

From the point of view of comparability and consistency between the pension plan financial statements and the University financial statements, we should first examine the guidelines for financial reporting for pension plans. Beginning with the financial statements for the year ending June 30, 2012, the University of Toronto Pension Plan and the University of Toronto (OISE) Pension Plan (the "Pension Plans") will be applying the new Part IV (section 4600) of the CICA Handbook.

The Pension Plans have, in the past, measured the pension obligation on their financial statements using funding assumptions, i.e. the pension obligation was the same obligation used by the University's actuaries to report to governance and regulators on the funding status of the University's registered pension plans.

The main impact of the new section, which is relevant to this report, is that the University can choose to measure the pension obligation on the Pension Plans' financial statements using **either funding assumptions or accounting assumptions**.

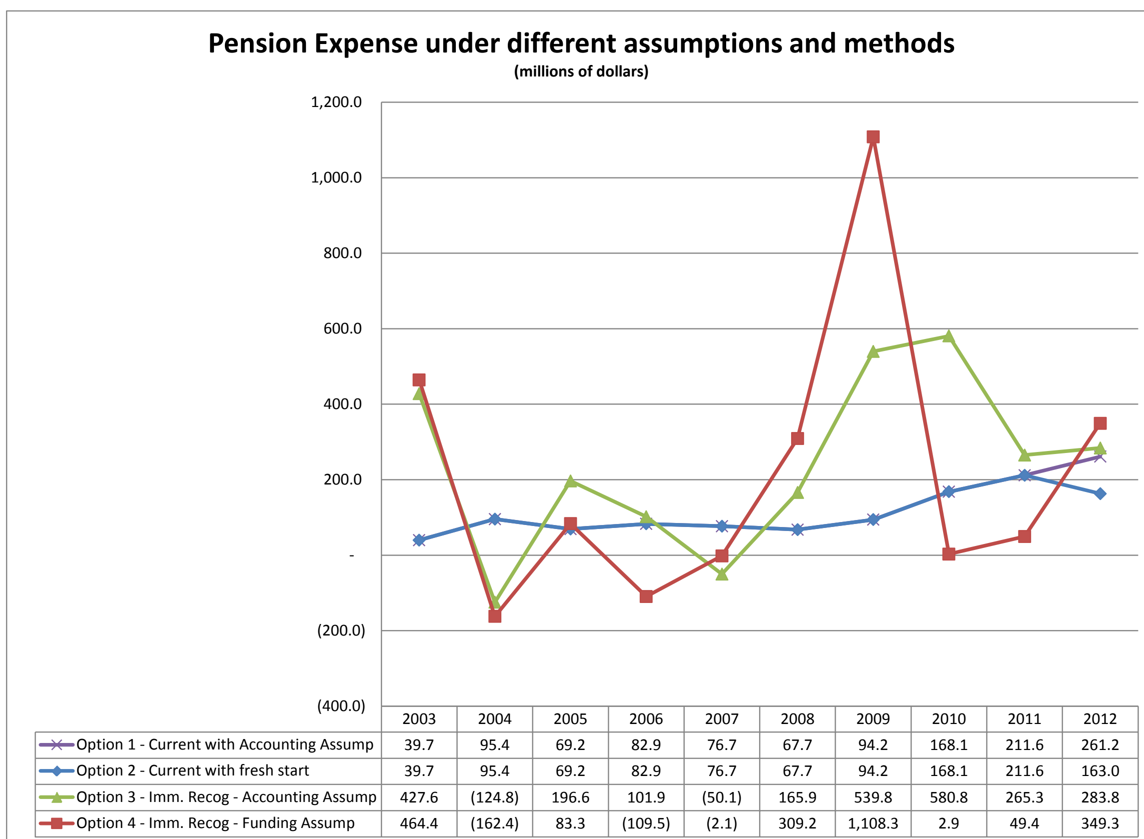
- It could be argued that the most relevant measurement of the pension obligation from a going concern point of view (which a University would be considered) would be to use funding assumptions, since they are based on longer term expectations rather than accounting assumptions which are influenced by short-term market conditions. It is very unlikely that the University would discontinue operations and wind up its Pension Plans in the foreseeable future, so it could be argued that accounting assumptions are not a relevant measurement of the obligation.

- It would be beneficial for the Pension Plans and the University to follow the same approach for valuing the pension obligations, since it makes more sense for users to see the same approach used regardless of whether the obligation is on the University's financial statements or on the financial statements of the Pension Plans. Having a different valuation approach does confuse users as to the actual obligation to members of the Pension Plans.

- Since pension financial health is a critical component of the University's financial health, and since key pension decisions are based on the actuarial report which is prepared on a funding basis, the pension expense and pension obligation on the University financial statements should be based on the same principles.

The following graph shows what the pension expense would have been under the four options being, our current approach (option 1), our current approach but write-off to net assets all accumulated balances noted above (option 2), the immediate recognition approach using accounting assumptions (option 3) and the immediate recognition approach using funding assumptions (option 4). This graph assumes that the various approaches have been adopted prior to 2003 in order to provide a sense of possible variability.

As you can see from the graph, these different approaches generate quite different results on a year by year basis with the most variability found with immediate recognition as compared to the deferred and amortization approach. Irrespective of the method used, the impact of investment losses and actuarial gains and losses will eventually all makes its way in the statement of operations.



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Option 1 - Current with Accounting Assump	39.7	95.4	69.2	82.9	76.7	67.7	94.2	168.1	211.6	261.2
Option 2 - Current with fresh start	39.7	95.4	69.2	82.9	76.7	67.7	94.2	168.1	211.6	163.0
Option 3 - Imm. Recog - Accounting Assump	427.6	(124.8)	196.6	101.9	(50.1)	165.9	539.8	580.8	265.3	283.8
Option 4 - Imm. Recog - Funding Assump	464.4	(162.4)	83.3	(109.5)	(2.1)	309.2	1,108.3	2.9	49.4	349.3

<u>Selections</u>

The University settled on the the immediate recognition approach (changing from the deferral and amortization approach), recognizing all unamortized actuarial gains/losses as of April 30, 2011 in

opening net assets as of May 1, 2011. The University would use funding assumptions (which is a change from the current use of accounting assumptions).

The impact related to employee future benefits on net assets at May 1, 2011 would be a reduction of approximately $926 million, made up of the following:

- Recognition of unamortized net actuarial losses of $1,268.9 million, unamortized past service costs of $74.7 million, and unamortized transitional assets of $67.2 million. The result would be a net reduction in net assets of $1,276.4 million ($1,268.9 + $74.7 - $67.2), and

- Change in accounting policy from using accounting assumptions to measure the employee future benefits obligation to using funding assumptions. The result would be a net increase in net assets of approximately $350 million (amounts to be confirmed by our actuaries)

It is assumed that the Pension Plans' financial statements will continue to use the immediate recognition approach, and continue to use funding assumptions when the plans implement Part IV of the CICA Handbook for the Pension Plans' financial statements for the year ended June 30, 2012.

Capital Assets at Fair Value

Current Accounting Practice

The current accounting practice is to record purchased capital assets (land, buildings, equipment) at cost. Buildings, equipment/furnishings and library books are amortized on a straight-line basis at various rates. Land is not amortized.

Policy Choices

The new accounting rules will allow the University, on a one-time-only basis, to restate all or part of its capital asset value at May 1, 2011 at fair value and deem that fair value to be considered as its cost for future periods. Any increase in the value of our capital assets will automatically increase the value of the University's net assets.

The University's lands (mainly UTSC, UTM, St. George) are currently valued at $76.6 million. The appraised value of these lands has been determined to be $2,161.6 million at May 1, 2011 by an independent appraiser. The increased value of $ 2,085 million ($2,161.6 - $76.6) would be reported in our financial statements as both an increase to our assets and net assets.

The significant amount of construction activity on all three campuses in the past decade would suggest that there is not a lot of additional value in our buildings, since many new buildings have been added in recent years and many existing buildings have been renovated, which would suggest that the values recorded are relatively current. Also, the value inherent in the University's buildings really reflects land values (future development potential) and therefore appraising our buildings may not provide additional significant value.

There is also little long-term benefit to be derived by revaluing buildings at fair value, but potential future grief. Unlike land, any increase in the value of the University's buildings will have to be charged (amortized) to the statement of operations over a period of about 40 years thereby creating future losses. The benefit of restating the value of buildings to its appraised values would be eliminated over time. Rating agencies may not view these future losses favourably.

Advantages of revaluing land at fair values:

- Unlike buildings, land is not amortized and its value would remain in net assets in perpetuity.
- A greater understanding of the financial position of the University will be achieved since all assets and obligations would finally approximate fair value at a point in time, even without revaluing buildings.
- Recording land at fair values may have a favourable impact on the University's credit ratings thereby reducing future cost of borrowing.

Disadvantages of revaluing land at fair values:

- The significant increase in net assets may be viewed unfavourably in collective bargaining, by donors and by governments.
- The borrowing capacity parameters will have to be revisited since the 40% net asset formula for external borrowing may no longer be suitable.

Selection

The University settled on valuing its land at fair value as of May 1, 2011, using the certified appraisal that was deemed acceptable by our external auditors. The result would be the recognition of the increase in fair value as an increase in net assets at the date of transition of $2,085 million ($2,161.6 million less the recorded value of $76.6 million).

Financial Assets and Financial Liabilities

Overview

The University's investments, including derivatives are currently recorded at fair values since it classifies most financial instruments as held for trading. In the future, the university will be guided by the rules for private enterprises which are found in CICA Handbook section 3856 and summarized in the table below. This new guidance provides options, which if adopted, results in no change to the current approach used by the University.

Investment Type	**Current**	**New Rules**	**Selected for 2013**
Equities in Active Markets	Fair Value	Fair Value	Fair Value
Fixed income securities and others	Fair Value	Cost *	Fair Value
Derivatives not in an effective hedging relationship	Fair Value	Fair Value	Fair Value
Derivatives in an effective hedging relationship	Fair Value	Cost *	Fair Value
Investment measured using:	Bid prices	Closing Prices	Closing Prices

- Option to elect to use fair values

Subsequent Measurement

As noted above, under the new guidelines, the general rule is that financial instruments are measured at cost or amortized cost except for:

- Equities which are traded in an active market which are measured at fair value using closing prices,
- Derivative contracts (except those designated in a hedging relationship) which are measured at fair value, and

- Any financial assets (like fixed income securities and private investment interests) that the University may elect to measure at fair value by irrevocable designation a) at initial application of this section, or b) when an equity investment is no longer listed in an active market.

This means that equities traded in an active market must be measured at fair value (closing price), derivative contracts not in hedging relationships must be measured at fair value, all other financial assets, such as fixed income securities, can be measured at amortized cost (less impairment for equities), or designated to be measured at fair value.

Financial liabilities (debentures) can continue to be recorded at amortized cost or designated to be measured at fair value. The University will continue to record its financial liabilities at amortized cost.

Selection

The University will continue to record its financial assets at fair value by electing to measure equities not traded in active markets and other financial assets, such as fixed income securities, at fair value. This will result in no change to our current valuation of financial assets and financial liabilities. Bonds and publicly traded equities will now have to be measured using closing prices instead of the bid prices.

Advantages:

- No change to our current practices, procedures and results,
- The use of fair values has proven to be easily understandable and to be the most objective measurement for the valuation of our investments, and
- Less prone to misinterpretation of the results.

Impact on financial statements

At April 30, 2011, the use of closing prices instead of bid prices for valuing the University's investments would have increased investment values by $1.1 million and would have increased net assets by the same amount.

Other Impacts

Financial Statement Presentation

For the April 30, 2013 financial statements, in addition to a balance sheet for the current year (April 30, 2013) and the comparative year (April 30, 2012), the University will need to also present

the balance sheet at the transition date (May 1, 2011). These statements would all be in accordance with Parts II and III of the CICA Handbook. The third column would be required only for the April 30, 2013 fiscal year.

Financial Statement Disclosures

The following additional disclosures will be required for the April 30, 2013 year end only:

- A reconciliation of opening net assets (May 1, 2011) with the net assets previously reported for April 30, 2011,
- A reconciliation of net income on the Statement of Operations for the comparative year (year ended April 30, 2012) with net income previously reported for the year ended April 30, 2012,
- Transitional note disclosures of any significant new accounting policies or changes in accounting policies that were adopted on transition, and
- Transitional note disclosures of any optional elections/exemptions that were applied on transition.

The following are additional ongoing disclosures:

- Amounts payable at year end in respect of government remittances including, for example, provincial sales taxes and HST, payroll taxes, health taxes and workplace safety insurance premiums.

Other disclosures will be eliminated:

- Details of future accounting changes
- Capital management

Employee future benefit disclosures in the notes to the financial statements could also be simplified as the requirements are less stringent for private enterprises.

Audit implications

The opening and comparative financial statements will not have been previously audited by the external auditors under the new accounting guidelines. In order to avoid an explicit disclaimer on

the comparatives and in the audit report, the University will have to engage the external auditors to perform the assurance work necessary to provide a two-year audit opinion. It is anticipated that the additional work required would not be particularly onerous since the changes are limited to the items detailed in this impact document.

Financial impact of selections on balance sheet

The net impact of adopting the new accounting and transitional choices discussed above on the financial statements for the year ended April 30, 2013 is a net increase in net assets at the date of transition (May 1, 2011) of approximately $1.2 billion. Appendix A shows the restated balance sheet for 2011 which take into account the changes selected for employee future benefits, capital assets and financial assets which will be included in 2013 along with the April 30, 2013 and April 30, 2012 balance sheets.

Appendix A

UNIVERSITY OF TORONTO
BALANCE SHEET
(millions of dollars)

	Restated 2011	2011	Change
ASSETS			
Current			
Cash and cash equivalents	99.3	99.3	
Short-term investments	535.1	535.1	
Accounts receivable	104.8	104.8	
Inventories and prepaid expenses	16.9	16.9	
	756.1	756.1	
Long-term accounts receivable	36.8	36.8	
Investments	2,079.5	2,078.4	1.1
Capital assets, net	3,854.2	1,769.2	2,085.0
	6,726.6	4,640.5	2,086.1
LIABILITIES			
Current			
Accounts payable and accrued liabilities	248.0	248.0	
Deferred contributions	370.3	370.3	
	618.3	618.3	
Accrued pension liability	1,042.6	233.5	809.1
Employee future benefit obligation other than pension	496.5	379.2	117.3
Series A senior unsecured debenture	158.9	158.9	
Series B senior unsecured debenture	199.1	199.1	
Series C senior unsecured debenture	74.7	74.7	
Series D senior unsecured debenture	74.4	74.4	
Other long-term debt	19.7	19.7	
Deferred capital contributions	986.3	986.3	
	3,670.5	2,744.1	926.4
NET ASSETS			
Unrestricted deficit	(173.9)	(173.9)	
Internally restricted	1,689.8	530.9	1,158.9
Endowments	1,540.2	1,539.4	0.8
	3,056.1	1,896.4	1,159.7
	6,726.6	4,640.5	2,086.1