UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 66 OF THE AUDIT COMMITTEE

October 30, 2002

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, October 30, 2002 at 5:00 p.m. in the Council Chamber, Simcoe Hall, with the following members present:

Mr. Robert S. Weiss (In the Chair)
Mr. George E. Myhal (Vice-Chair)
Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. Edward Ng
Mr. Richard Nunn*
Mr. Roger P. Parkinson

Mr. Felix Chee, Vice-President - Business Affairs

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

Secretariat:

Mr. Neil Dobbs
Ms Beverley Stefureak

Regrets:

Ms Kim McLean

* Participated by telephone.

In Attendance:

Mr. Curt Auwaerter, Vice-President - Finance, University of Toronto Press*
Ms Kathryn Bennett, Senior Vice-President - Administration and Human Resources, University of Toronto Press*
Mr. Keith B. Bowman, Ernst & Young
Mr. George Meadows, President and Publisher, University of Toronto Press*
Mr. Pierre Piché, Associate Controller
Mr. Allan H. Shapira, Hewitt Associates**

* In attendance for item 2.
** In attendance for item 3.

ITEMS 2 AND 3 CONTAIN RECOMMENDATIONS TO THE BUSINESS BOARD FOR APPROVAL

1. Report of the Previous Meeting

Report Number 65 (June 19, 2002) was approved.

2. University of Toronto Press: Annual Report and Financial Statements, for the Year Ended April 30, 2002

The Chair observed that the Business Board had delegated to the Audit Committee the responsibility for the Governing Council's - the controlling corporation's - stewardship with respect to the U of T Press. The Press was a separate corporation with its own Board. The financial statements had been reviewed and approved by the Press Board's Audit Committee and its Executive Committee and had been distributed to all members of that Board. Therefore, the Governing Council's Audit Committee was not charged with conducting a detailed review of the statements. Rather, this review should be seen as analogous to an annual shareholders' meeting. The Press's annual report and financial statements would be on the Business Board agenda, but as a "consent" item. Given the Audit Committee's review, there would be no presentation of the item at the Business Board, and there would normally be no discussion, unless a member gives notice of concerns. Because the annual report and financial statements would be approved by the Press's own Board, the Audit Committee was asked to recommend that the Business Board "accept" rather than "approve" those documents. The Chair disclosed that Mr. Chee, Mr. Parkinson and himself were directors of the University of Toronto Press. Mr. Parkinson was Chair of the Board. They would, to avoid any concern about a of conflict of roles, not make or second motions or vote.

Mr. Chee said that the annual report summarized the results of the Press for the 2001-02 year and the business context in which they were achieved.

Mr. Meadows presented the annual report and financial statements. The Press had achieved a good year in a very tough environment for publishers, printers, book distributors and book retailers. In addition to the well know problems that led to the merger of Canada's two largest bookselling chains, one major publisher and distributor and several printing companies had become bankrupt. The Press had achieved a net income of $705,000 before paying $235,000 of participating interest to the University for its initial $3-million of capital funding and before transferring the same amount to the University's scholarly publishing trust fund. The Press's conservative business strategy had served the it very well, enabling it to achieve its overarching goal of funding a well-respected program of publishing scholarly books and journals. The most substantial capital expenditure for the year had been the establishment of a new bookstore location at the University of Toronto at Scarborough. The store, which was proving to be a great success, had replaced a temporary store located for the past twenty years in a portable building.

Mr. Meadows said that the auditors had provided a clean opinion on the statements. Differences had been adjusted, leading to an increase in reported net income. The adjustments related to accounting for returns of unsold books, which retailers were permitted to return to publishers at any time. The University of Toronto Press's system for handling returns was a good one but had been strained to the limit by returns from a newly merged book chain and returns of some imprints recently assumed from a bankrupt publisher / distributor.

Mr. Meadows reported that the Press was behind budget for the 2002-03 year. The air-conditioning system at the Downsview printing plant and warehouse had broken down, and its replacement required the concurrent replacement of the electrical system. A broken water main near the plant had caused further problems. Mr. Meadows hoped that the Press would be able to bring its operations back up to budget by the end of the fiscal year.

Mr. Meadows responded to questions. More general topics included the following.

2. University of Toronto Press: Annual Report and Financial Statements, for the Year Ended April 30, 2002 (Cont'd)

(a) Returns of books. In response to a question, Mr. Meadows said that on average, 30% of books shipped to retailers were returned. This was considerably better than the industry average of 40% to 45%, largely because of the Press's publication of scholarly books in contrast to fiction and trade books.

(b) Financial relationship with the University. In response to questions, Mr. Meadows said that the Press's financial relationships with the University were, by and large, at market rates. The Chair noted that the Press paid rent to the University for some of its premises and paid operating costs for others. Mr. Chee added that the Press received a line of credit from the University at a preferred rate of prime minus 1%. In addition, its employees were members of the pension plan, and the Press, like the University, currently made no employer pension-plan contributions. The key factor to be understood, however, was that the main reason for the existence of the Press was to carry out its program of publishing scholarly books and journals, which tended to sell many fewer copies than trade and text books and which were therefore often unprofitable. In the absence of an income stream from its other operations, the Press would be unable to continue its scholarly publishing program without subsidy from the University. It would, therefore, be in the University's best interest that the Press's franchise on campus be maintained and expanded.

(c) Accounts receivable. Accounts were normally paid by retailers in ninety days, although one large retailer took somewhat longer. Accounts receivable were reduced by an allowance for potential returns and uncollected accounts. The size of that reserve was determined on the basis of a judgement by the Press's Credit Department, which served all of the Press's business operations. The reserve was a conservative one, which had been endorsed by the external auditors. The Audit Committee and the Executive Committee of the Press Board had looked carefully at the accounting for accounts receivable and were satisfied with it. The Press had been less exposed than other publishers to credit problems with respect to a major bookstore chain; the Press had both kept careful track of that account receivable and had given that chain priority in dealing with returns, so that the size of the credit for returns could be established and the remainder of the receivable collected.

On behalf of the Committee, the Chair congratulated Mr. Meadows, Ms Bennett, Mr. Auwaerter and all of the staff of the University of Toronto Press on their remarkable success in both maintaining its excellent scholarly publishing program and also earning a net income in a very difficult year for its businesses.

On the recommendation of the Vice-President, Business Affairs,

YOUR COMMITTEE RECOMMENDS

THAT the annual report and financial statements of the University of Toronto Press for the year ended April 30th, 2002, a copy of which are attached hereto as Appendix "A", be accepted.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2002

The Chair said that the Committee's duty with respect to the annual financial report on the pension plans was to assure itself, the Business Board and the University community that the three pension plans (the main University plan, the plan for OISE employees before the merger

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2002 (Cont'd)

with U of T, and the Supplemental Retirement Arrangement) were in solid financial shape - that they were being properly funded, properly managed and properly accounted for. The Committee would be asked, following its discussion, to recommend to the Business Board that the financial statements for the two registered plans be approved. Approval was required prior to the submission of the financial statements to the Financial Services Commission of Ontario. The 2001-02 year had been a difficult one for pension plans, given the substantial negative returns in the equity markets. The annual report on all University investments, including the pension master trust investments, would be made to the Business Board in the spring. While members could raise significant questions about investment performance, the report to the Business Board was the key one with respect to accountability for investment performance, and the Audit Committee should be careful not to lose its focus on the overall health of the plans.

Mr. Chee said that the focus of the Audit Committee' attention was the financial statements. The assets of the two registered pension plans were combined in a master trust, with 95% of the assets being those of the main University plan and 5% being those of the OISE plan. In addition, the University had, for accounting purposes, was setting aside assets in a "fund for specific purposes" with the aim of matching its obligations under the Supplemental Retirement Arrangement (S.R.A.) For the reporting period, investment returns had been down substantially, although the master trust had outperformed its benchmark. The accrued liability of the registered pension plan had grown by 23.3% since 1998, with the assets having declined by 4.8%. The accrued liability of the S.R.A. was growing at a faster rate than that of the registered plan, having increased by 66.3% since 1998. The S.R.A. topped up retirement income over the maximum permitted by regulations under the Income Tax Act. Salary increases over time were increasing the number of employees eligible for benefits under the S.R.A. At the same time, improvements to the registered pension plan had reduced the pensionable earnings at which the maximum pension was reached under the registered plan, further adding to the liability of the S.R.A.
The actuarial surplus in the University's main registered pension plan as at July 1, 2002 was $246.0-million. The market value of the surplus as of that date was, however, only $87.1-million. With further declines in the equity markets, it was likely that the market surplus as at the September 30 end of the third quarter of 2002 would be zero or even negative.

Mr. Chee, Mr. Bowman and Mr. Shapira responded to questions. Among the topics were the following.

(a) University contributions to the pension plan. The Income Tax Act prevented employer contributions to registered pension plans when their actuarial surplus, as of the date of their most recent filing, exceeded 10% of the accrued actuarial liability or twice the current service cost. The legislative provision was intended to prevent taxable employers from using excess pension plan contributions to reduce their taxable net incomes, but the provision also applied to not-for-profit institutions. The University would therefore, be unable to make contributions to the plan for 2002-03, even if the market surplus was (as a result of continued equity market declines) reduced to zero. This represented an unusual situation brought about by a precipitous stock-market decline, causing a large gap between the market value and the actuarial value of the assets. Mr. Chee stated that the administration was reviewing the plan and possible future developments. Among the key steps was a review of the liabilities of the plans and the appropriate policy for investing the assets in the light of those liabilities. He would recommend that the approach taken be the most conservative available. The current service cost for 2002 for the main registered plan was $59.6-million, including required participant contributions of $22.3-million. Were employer contributions to be permitted and required, therefore, the cost to the University would be $37.8-million for the year.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2002 (Cont'd)

(b) Need for a "subsequent event" note? A member asked whether the further decline in the market value of the assets since the date of the financial statements should be disclosed in a "subsequent event" note. Mr. Bowman replied in the negative. Such a note would be appropriate only in the event of a calamitous event permanently impairing the value of the assets. Market values of securities changed every day. On the other hand, the liability of the plan was payable over many years. Mr. Shapira concurred with this view. For example, the market value of the plan would likely increase substantially in October.

(c) Need for a review of the actuarial assumptions? A member asked whether, given the divergence of investment performance from the actuarially assumed performance, it would be appropriate for the administration and the actuaries to review the actuarial assumptions. Mr. Shapira replied that the actuarial assumptions were always under review, but it was essential to take a long-term perspective. With respect to the assumed return on the assets in the pension fund, there had been frequent criticisms two years ago that they were too conservative. Currently, the concern was that the assumed return was too high. The key to a good actuarial valuation was achieving the correct relationship between the assumed real (after-inflation) rate of salary increases and the assumed real (after inflation) rate of return on the assets. Both nominal assumptions were linked to inflation. If, for example, the underlying rate of inflation declined, then both salary increases and the return on assets would be assumed to decline. With respect to the return on assets, the assumed annual rate of inflation was 3%, and the assumed real rate of return on assets a further 4% per year, for a nominal return of 7% per year. Those assumptions still appeared to be reasonable. It could be argued that the assumed rate of inflation and nominal rate of return should both be reduced by one half of 1%, but the outcome of doing so would be marginal because the reduced rate of inflation would also apply to the liability side – the assumed rate of increase in salaries and indexed pension payments.

(d) Investment policy. The Pension Fund Investment Policy currently included three return objectives, all expressed in terms of average rate of return over any four-year period: (i) to achieve a real rate of return (after inflation) of 4% per year (matching the actuarial assumption); (ii) to exceed a composite benchmark return that combined standard market indices; and (iii) to exceed the return achieved by the median fund of a comparative measurement universe of peer funds. Mr. Chee noted that management at the University of Toronto Asset Management Corporation (UTAM) had stressed the second criterion, which showed how the fund performed compared to how a passively managed fund would have performed. At a May briefing session on investment matters for members of the Governing Council and the Business Board, the general view was that it was more important to focus on how the fund performed compared to peer funds. The selection of criteria had a number of ramifications, including the basis for incentive compensation for UTAM staff.

A member observed that the poor performance of the University's pension fund relative to others was the outcome of two factors. First, the asset mix contained in the investment policy provided that 60% of the fund be invested in stocks and 40% in fixed-income securities. In many other Canadian pension funds, a substantially lower proportion was invested in stocks, some as low as 40%, and those funds had therefore suffered less in a period of negative stock-market returns. Second, an unusually large proportion of the equity component of the University's pension fund was invested in foreign stocks or in derivatives with returns based on foreign stock indices, with only 8.6% being invested in Canadian stocks. Over 50% of the University fund was invested in foreign equities. For the median Canadian fund, only 23% was invested in foreign equities, with 34% being invested in Canadian stocks. For the past two years, fixed-income securities had achieved positive returns, whereas equity markets had incurred large losses, and the losses on the

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2002 (Cont'd)

Canadian equity market were lower than those elsewhere. The policy asset mix had been approved by the Business Board, but it was unfortunate that it had not been subjected to review. It had been clear that the sudden decline in the U.S. Nasdaq Index signaled the beginning of a bear market in stocks, and a change in asset mix should have been made.

Mr. Chee agreed that, in hindsight, such a change would have been highly advantageous. The basic asset mix of 60% equities and 40% bonds was not atypical for pension funds. The Pension Fund Master Trust Investment Policy provided, however, for a range of both equities and fixed income securities that would have allowed the fund to reduce equities to a 50% of the fund. UTAM had not exercised the discretion to make major shifts in asset mix, and indeed the University would not want UTAM to exercise such discretion unless it had the competence to do so well. It was Mr. Chee's view that UTAM should determine an appropriate asset mix, and be squarely responsible for doing so, with the University specifying only its needed return and its risk tolerance. Thereafter, tactical asset allocation would clearly be expected. Mr. Chee agreed that the poor performance relative to other funds had been entirely the outcome of asset mix. Performance within individual asset categories had been better than that of the median peer fund.

Mr. Chee noted that before the establishment of UTAM, the investment of the University's pension plan had been typical of other plans. Performance had often been below that of the median fund, but the cause had been below-median performance in each asset class. The University had established UTAM because of its new stress on its objective of becoming one of the leading public research universities in the world. That meant competing for outstanding faculty members with the foremost public research universities in the U.S., which required the University of Toronto achieve the higher investment returns that had been typically achieved by U.S. university endowments and pension funds. UTAM had therefore been established and had initiated an investment program much more like that of the leading U.S. universities, including more substantial allocations to investments in private equity, alternative investments (including hedge funds) and a higher proportion of U.S. and non-North-American equities. UTAM had begun operations in May 2000, and it was too early to tell whether its model would prove to be a good one or a bad one in the long term. What was clear in hindsight was that in the two and one half years since the establishment of UTAM, asset classes that had underperformed over the long term - bonds compared to stocks and Canadian stocks compared to stocks elsewhere - had outperformed in the short term, and UTAM's returns had compared poorly as a result.

Mr. Chee stressed that the problem was not only one for UTAM. Rather, the University itself had to determine an appropriate balance between its wish for a strong return and its willingness to assume the short-term risk needed to obtain higher long-term returns. If long-term returns were lower, the University would ultimately have to spend more of other operating income on its operations and its pension benefits. But if it wished for better returns in the long term, that would require a more aggressive investment policy that would inevitably require even larger spending from the operating budget in some short-term periods to compensate for the increased volatility of returns arising from aggressive investments. The University might, for example, decide that it had too little fiscal flexibility to accept the risk inherent in its current aggressive investment policy. That would, however, have implications for longer term returns.

The Chair observed that this was a key question to be resolved at other levels of governance.

In the course of discussion, Mr. Chee stated that the pension plans would be properly funded. In the absence of improved returns on the pension fund, the University would resume employer contributions to ensure that the plan was fully funded.

3. Pension Plans: Annual Financial Report for the Year ended June 30, 2002 (Cont'd)

The Chair noted that an important concern, stated in the report, was the rate of growth in the accrued liability, which was outpacing the rate of growth in the assets. The administration was aware of this problem and was taking the necessary steps to formulate a plan of action. He enquired about timelines. Mr. Chee replied that he was currently completing his review of the accrued liability of the pension plans and the University's endowment. A great deal of analysis and consultation was being carried out. He anticipated that he would be in a position to report the outcome in the first quarter of 2003. That outcome would be reflected in the proposed budget and later in the long-range budget plan and in proposals for revised investment policies.

On the recommendation of the Vice-President, Business Affairs,

YOUR BOARD RECOMMENDS

(a) THAT the audited financial statements of the University of Toronto Pension Plan, June 30th, 2002, a copy of which is included in Appendix "B" hereto, be approved; and

(b) THAT the audited financial statements of the University of Toronto (OISE) Pension Plan, June 30th, 2002, a copy of which is included in Appendix "B" hereto, be approved.

4. Chair's Remarks

The Chair welcomed back all members and especially welcomed Mr. Ng to membership of the Committee and Mr. Myhal to his new role as Vice-Chair. He noted that the Committee's terms of reference had been included in the agenda package. While the Committee received reports on a broad range of matters, it would be important that it maintain its focus on its responsibilities with respect to those matters, as described in the terms of reference. The calendar of business, which outlined the items planned to come before the Committee during the year, appeared later on the agenda.

The Chair noted that, unlike most other Governing Council Committees, the Audit Committee normally met in closed session. That meant that meetings were open only to members, as well as any members of the Business Board or Governing Council who might wish to attend. In addition, appropriate members of the University staff attended. From time to time the Committee would move *in camera* to discuss particularly sensitive matters off the record. In those cases, only members and specified staff would attend. The Committee received a great deal of highly confidential material. Some items would become public after the Committee dealt with them, for example the University's financial statements. Other material, however, such as the internal and external auditors' plans would remain private. The Governing Council's "Guidelines on Confidentiality of Documents and Proceedings" stated that all proceedings taking place in closed session were not to be discussed outside of the Committee, except with people who would be entitled to attend the meeting - other Committee members, Business Board members or Governing Council members. Appropriate documentation and the record of the Committee's proceedings would be released by the Secretariat in accordance with usual practice or the Chair's instructions. Members were therefore asked to treat the information they received as members, and the Committee's discussions, with a high level of discretion.

5. Business Arising from the Report of the Previous Meeting

The Chair referred to the "follow-up list" attached to the report of the previous meeting. Many of the items would be dealt with at the next meeting. Mr. Chee reviewed a number of the items on the list.

A member referred to the item concerning the risk assessment profile, which would be presented to the Committee at its next meeting. He referred to the student survey of Canadian universities, published in the *Globe and Mail*, in which the University of Toronto ranked poorly. He asked whether reputational risk was an element of the risk assessment. Ms Brown replied that for a public institution reputational risk was an element in all areas. The Chair added that the assessment made specific reference to the competition for the best faculty and students, which depended a great deal on the University's reputation. The Audit Committee was not responsible for the University's activities to protect and enhance its reputation; if, however, the Committee was not satisfied that the risk was being addressed, it would (as usual) draw that fact to the attention of the appropriate officers or committee.

6. Legal Services: Summary Report, 2001-02

The Chair said that the Summary Report, Legal Services was presented for information, as a mechanism for monitoring contingent liability and assessing risk.

Two members expressed concern about the large variance between actual and budgeted expenditures. Mr. Chee responded that the variance was largely the result of too-conservative budgeting. The more important issue, in his view, was whether the University should acquire in-house legal expertise. His concerns were for cost-effectiveness and for reducing the risk related to having a great deal of institutional memory residing outside the University. He recognized the difficulty in effective in-house support to an institution with heterogeneous legal questions. However, an internal legal department could deal with many matters and, more importantly, act as the sole interface between divisions and outside legal firms.

The Chair enquired as to whether escalating costs were indicative of a rising risk exposure of which the Audit Committee should be aware. Mr. Chee responded that costs of employment-related actions had risen significantly, but those actions were usually one-off. Corporate legal costs had risen because of the capital expansion and the intense activity in the advancement area. Mr. Charpentier added that the costs of faculty and student grievances, appeals and discipline hearings had been rising slowly but consistently.

Several members agreed that in-house legal expertise would be a positive move, provided that it would be possible to build the critical mass needed to provide good legal service to the University. Further, they saw a legal department as providing an important filtering activity that would undoubtedly result in cost savings overall.

7. Enrolment Audit, 2001-02

The Chair reminded members that this audit report had been distributed as a "consent" item, and no member had requested that it be discussed. The Enrolment Audit was performed annually by Ernst & Young, with the aid of the Internal Audit Department, for the Ministry of Training, Colleges and Universities. The audit verified the enrolment report provided to the Ministry as the basis of the University's claim for operating grants. The audit also reviewed the University's procedures to ensure that students exempted from the higher fees usually charged to foreign students were entitled to that exemption. There were no questions.

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8. Report of the Administration

Mr. Chee, Ms Brown, Mr. Charpentier, and Mr. Britt stated that they knew of no matters not on the agenda that should be drawn to the attention of the Committee at this time.

9. Calendar of Business, 2002-03

The Chair referred to the Calendar of Business for 2002-03, which laid out the business planned to come before the Committee for the year. Of course, developments might well result in additional items that would require the Committee's attention. The Chair advised that the Calendar of Business would be kept up to date to reflect the business to come forward to each meeting.

10. University of Toronto Innovations Foundation: Annual Report and Financial Statements for the Year ended April 30, 2002

The Chair informed members that the financial statements for the University of Toronto Innovations Foundation had been distributed but, because of unforeseen circumstances, the accompanying Annual Report had not been completed. It could have been presented orally but, in the Chair's view, that would not have been an effective way for members to review the report. Accordingly, consideration of the item would be deferred to the next regularly scheduled meeting or to another appropriate time.

11. Dates of Next Meetings

The Chair reminded members that the Audit Committee **orientation** was scheduled for **Monday, November 18, 2002 at 5:00 p.m.** The orientation was intended for all members - not only new members. Topics planned included: the organizational structure of the University, the role of the financial services departments (including financial services, procurement services, and risk management and insurance), a review of the overall financial health of the University, a review of the control environment, a review of controls in the asset-management process, and a review of the internal audit process.

The next regular meeting was scheduled for **Wednesday, November 27, 2002 at 5:00 p.m.** This meeting would (among other things):

- review the interim report of the Internal Auditor;
- review the annual financial and operational risk-assessment profile; and
- review the external auditors' management letter and the administration's response, the external audit plan and engagement letter for next year, the report on the external auditors' consulting assignments, and the external audit fees.

The meeting adjourned at 7:00 p.m.

Secretary

Chair

November 4, 2002