

**President's Advisory Committee
on the
Impact of the Current
Economic Situation
(PACICES)**

Interim Report

June 12, 2009

Chair's Message

The PACICES committee was established at the beginning of 2009 to provide strategic advice and develop strategies to ensure the long-term sustainability of the University. Its members include faculty, students, members of various employee groups across campus, and members of the Board of Governors. Each person has brought important perspectives and experience to the process. The Committee was also able to draw on numerous internal and external subject matter experts as it developed its interim recommendations.

Our approach has been to look at the fundamental issues on the funding side such as government resources at both the provincial and federal levels, and also to extend our thinking about how the University spends its resources. We also want to challenge people to consider all possibilities to allow McMaster to continue to strengthen both its academic and research programs and secure greater financial certainty. Determining the final balance between these two objectives is a complex task, but we hope the Committee's work provides a range of options as well as clarity on the significant risks facing the University if solutions are not found in a timely manner.

Not all organizations would be open to such a broad and transparent approach to these challenges. Such a bold approach speaks to the willingness of McMaster's president to both recognize the significant challenges the institution is facing, and the importance of looking at all of the possible remedies before determining a comprehensive approach. We also appreciate that the University has continued to operate while the Committee has been doing its work and that difficult decisions have had to be made by the University to meet its ongoing operating and financial needs.

Our report is interim. Our hope is that it will generate discussion and create the opportunity for people across the University to increase their understanding of McMaster's current financial situation, and to offer advice and guidance to the Committee as it finalizes its recommendations that will be delivered to the President before the end of the year.

The Committee looks forward to your comments.

David Lazzarato
Chair (PACICES)

Introduction

The President's Advisory Committee on the Impact of the Current Economic Situation (PACICES) was established by President Peter George in January 2009 to provide strategic advice and develop strategies to ensure the long-term sustainability of the University. (For full Terms of Reference see Appendix A) Committee members represent a cross section of the University community including the Faculties, the Board of Governors, staff, students, senior management and union leadership. (A complete list of Committee members is available in Appendix B)

Committee members have spent a great deal of time learning as much as possible about the institution's priorities and processes, the University's financial situation and beginning to consider recommendations to address the challenges McMaster faces. A number of internal resources and external experts have also provided valuable information and context for the Committee.

McMaster University's evolution over the past decade has been significant. Its student population has grown by more than 60%, its research enterprise has expanded to more than \$340 million in awards and approximately \$180 million a year in activity, its reputation as a world-class university has grown, and McMaster is consistently named one of only four Canadian universities listed in the Top 100 in the World. Preserving, protecting and building upon McMaster's strengths and its strong tradition of providing students with high quality and innovative education must not be compromised as it decides how to respond to the challenges it faces.

The University is a complex organization, in its structure, its governance, and in its varied roles both as a teaching and a research institution. Its funding system is equally complex as it receives revenues from many sources but primarily from the Provincial and Federal Governments, together with tuition fees that are regulated by the Province. Therefore, it does not control its sources of revenues and a significant portion of the funds that it receives are targeted to specific uses. These factors result in a structural situation where the University has limited flexibility in deciding how to use the resources it does receive. While these issues are common among all universities in Ontario, this fact does not diminish the burden these realities place on McMaster.

While the Committee's work is not yet complete, we wanted to provide an interim report on our work, findings and recommendations to date for the President to begin to consider.

There is still much work ahead and the Committee will continue to meet over the summer. Consultation with the McMaster community will begin in early September, and it is hoped that there will be broad involvement from all members of the McMaster community.

Not all of the consequences are yet understood, but it is clear that the effects of the global economic crisis on Canada and Ontario, coupled with pre-existing financial strains on both the income and spending sides of the University, place McMaster at a critical juncture. Its vision, its long-term priorities, and the steps it takes in the short and medium term will determine the University's ability to achieve its goals and to maintain or extend its international reputation for excellence. The Committee believes that some decisions should be made and actions implemented before the end of this calendar year in order to protect the University against certain potentially serious long-term threats.

The Committee would like to thank all of those who have assisted in the process to date and encourages faculty, staff and students to be active participants in the consultation process that will take place in September. The Committee looks forward to working with the McMaster community to enhance and finalize this interim report.

Context

A number of issues contribute to the overall financial condition of the University. We have chosen to highlight eight factors at this time that are particularly significant.

1. McMaster has been proactive in the management of its costs over the past several years. All units have been asked to absorb inflationary increases in costs and while managers have found solutions, difficult decisions have had to be made. The result is that McMaster is in better financial condition than it would have been had it not taken the actions it has.
2. The provincial government has taken significant steps to close the funding gap but Ontario is still last in funding in Canada on a per capita basis, with operating grants per student of approximately \$6,100 versus a Canadian average of \$8,500 and a high of \$9,700¹. These are differences of 39% and 59%, respectively.
3. When government research grants are received they cover the direct costs of research but only a portion of the indirect costs². Therefore, the more successful the University is in securing research grants, the more resources are required from elsewhere in the operating and capital budgets to pay for the full cost of research. As a highly research-intensive university this financial disconnect is more acute for McMaster than many other Ontario universities.
4. Consistent with other universities in Ontario, McMaster prepares its internal reports and budgets predominantly on a cash basis and pursuant to the concepts of fund accounting and on a full accrual basis for the preparation of its financial statements. The use of different accounting conventions for different purposes has contributed to confusion and a lack of understanding in the McMaster community of some of the issues germane to the financial position of the University.
5. The Committee has reviewed a four-year projection of revenues, expenses and balance sheets (Appendix C) for the University and, based on moderate funding and cost inflation assumptions, and the use of the full accrual basis of accounting, the University is facing a potential deficit of between \$37 and \$86 million dollars for each of the fiscal years 2010-2013. The midpoint of that range of \$61 million represents 7.7% of projected 2010 total revenue of McMaster. The University has prepared its 2009-10 ongoing operating fund budget by implementing short-term cost saving strategies and by

¹ Source: Council of Ontario Universities, 2007 Resource Document, March 2007 (note that the data are taken from the year 2003/04, the last published year with national comparators).

² The cost of conducting research at a Canadian university such as McMaster includes not only the direct costs of the project but also a range of indirect costs. These indirect costs include many expenditures that are frequently taken for granted but are real costs incurred by the University to supply the infrastructure required to allow a sponsored research project to proceed. Indirect costs include support for the libraries, the provision and maintenance of space, computing and networking support, accounting and other administrative services, Health Physics, Security, etc.

not including the full cost of its pension deficit³, non-pension, post-retirement benefits⁴, the impact of investment losses on long-term assets and by funding one-time costs of \$22 million from departmental reserves. These types of short-term strategies will not be able to effectively address the financial challenges contained in the 2011-2013 projections.

6. Existing pension and benefits, including post-retirement benefits, for most employee groups at McMaster are comparable to its' peer institutions in Ontario and are among the best offered in Ontario (public or private sector). The funding deficit between the obligations and the assets available for the benefits has grown considerably, in part, due to the recent poor investment climate. At this time the pension deficit is estimated at approximately \$340 million (Appendix D) on a going concern basis and the present value of the expected future cost of post-retirement obligations, is estimated at approximately \$200 million; resulting in an underfunding situation of approximately \$540 million in total. Even if the University were to fund this gap over a twenty year period, the annual cost of funding these obligations, including the appreciation of the amounts for lost investment income, would be approximately \$50 million. Only \$28 million of this amount has been included in the projections for 2010, with nominal increases in the 2011-2013 years.

7. The University has \$29 million dollars still to raise for capital projects that have been approved to date.

8. The Available Expendable Resources (AER) of the University represents funds the University holds that do not have a committed purpose. These funds provide operating flexibility, support debt management and provide the ability to take advantage of opportunities as they arise. McMaster's AER have been seriously depleted in the last couple of years (\$204 million and \$108 million, respectively, at the end of fiscal 2008 and projected for the end of fiscal 2009) and the projected deficits identified earlier would eliminate all AER over the next three to four years. If this were to occur it would significantly increase financial risk and impair McMaster's ability to deliver on its mission and commitments.

Government

The current world-wide financial stresses are being felt at both the provincial and federal levels of government. The difficult financial state has reduced government revenue in the short-term, and near-term stimulus spending to help protect and reinforce the economy is adding long-term debt commitments that will eventually limit future government spending.

Universities have been fortunate that the Ontario government continues to make post secondary education a high priority. The most recent one-time funding announcement in Budget 2009 will allow full BIU funding for last year and the coming year. Operating grants to Ontario universities and colleges have increased by \$1.7 billion, or about 63 per cent, since 2002-03⁵, which speaks directly to the success of the *Reaching Higher*

³ Legally obligated payments are planned, however, no payments have been budgeted to fund the increasing deficit.

⁴ Amounts paid are expensed as incurred rather than accrued over service lives of employees.

⁵ Source: Ontario Government, Ministry of Training, Colleges and Universities
(<http://www.news.ontario.ca/tcu/en/2009/05/ontario-boosts-support-to-colleges-universities.html>)

Plan. Planning is now underway to develop a successor to *Reaching Higher* and this next incarnation of the provincial commitment to higher education will be fundamental to McMaster's ability to deliver on its promises to students.

The province is also contributing \$780 million in capital funding to universities and colleges to leverage the \$2 billion commitment from the federal government for campus renewal. Ottawa has continued to support the development of Canada's universities, their research, and opportunities for both researchers and graduate students through programs such as the Canada Foundation for Innovation.

These government commitments to higher education are important and they have been and will be very helpful in strengthening the University. However, one-time funding and grants that do not cover the full cost of activities do not address the structural financial issues facing universities today. Encouraging and working with government at all levels to find solutions to these long-term and fundamental funding challenges is paramount.

Recommendations

The interim recommendations of the PACICES follow:

Strategic

The University operates within regulatory and financial frameworks established by the Province of Ontario and the Government of Canada. It is also significantly influenced by the intellectual framework within the international community. To ensure that the University is well prepared to address the forces of change in this multi-stakeholder environment, the Committee recommends that the University:

- Undertake a formal re-examination of its mission and strategy. This will ensure that it remains responsive to forces that influence its relevance and fortunes.
- Establish a definition of excellence, and decide how to distinguish itself by choosing what it wants to do and how, and by choosing what it no longer wants to continue doing. This will provide clarity and direction to guide decision making.
- Evaluate opportunities that will increase internal and external partnerships. The objective is to improve the quality and efficiency of education and research.

Government

Given that Government funding represents a significant portion of the University's revenues, government relations play a key role in enabling the success of the University. McMaster University's strength in innovative teaching and research presents the ideal opportunity to take a leadership role in guiding the future of education and research in Ontario and Canada. To ensure that the University maximizes its funding and continues to have influence with government leaders and decision makers, the Committee recommends that the University:

- Establish an annual government and external relations strategy to be approved and monitored by the Board of Governors. This will raise the priority and profile of government relations, provide clear direction and focus, and define roles and responsibilities for all such communication and interaction, including the degree to which the University will coordinate efforts with various National, Provincial, faculty, staff and students organizations.
- Undertake a leadership role to bring together all stakeholders; government, university, business and others to discuss and develop strategies to guide the future of post secondary education and research. This will position the University to be an active participant and play a key role in defining future strategy as opposed to being impacted by future strategy.
- Inform the provincial and federal governments of actions undertaken by the University to address funding challenges and the impact of the current economic climate and request equitable treatment should government action address these challenges for other institutions. This will raise awareness with the government and position the University to act, as required.

Internal Leadership

Only through continuous, open and honest dialogue, debate, and communication will the University community become fully engaged and trusting of one another. The internal community needs as much information as practical about the issues facing the University and what is being done to manage them, and the University's management can only benefit from the constructive advice of others. The Committee recommends that the University:

- Increase and then maintain the level of two-way communication with all internal stakeholders. This will contribute to an increase in the understanding of the issues throughout the University and improve the level of trust within the McMaster community.

Operational – Financial

The financial structure of the University is very complex, and changing economic conditions can have a significant impact on the financial position of the University. The Committee came to realize that few members of the University community have a full and complete view of the University's financial challenges and opportunities. While the Finance Committee of the Board has a complete view of the University's financial situation, there is little oversight of the entire financial planning strategy within the existing operational planning committees. This leads to misunderstanding and the potential for poor decision making at an operational level. In addition, current budget processes and models are difficult to understand and lack transparency. The Committee recommends the University:

- Expand the mandate, and composition as appropriate, of the University Planning Committee to include a fiscal advisory role, considering all items affecting operating and capital budgets, research activity, trust and endowment funds and the cash position of the University in their annual processes. This will ensure that decisions are not made in isolation and that their financial implications are more fully understood.
- Establish financial indicators and policies that would be used by the Board to continually evaluate the financial position of the University. For example, a policy that includes a minimum level of Available Expendable Resources equal to the greater of 15% of revenue and 80% of external debt (projected to be \$117 million and \$125 million, respectively, at April 30, 2010). This will ensure that the financial impact of all decisions that require the approval of the Board of Governors be considered.
- Establish a new budget model that reflects all capital and operating costs, all other financial activities of the University and uses the accrual method of accounting for all activities. The objective is to provide greater transparency and understanding of University finances.

- Eliminate the projected annual deficits of between \$42 and \$86 million for each of fiscal years 2011-2013 through a combination of new, net revenue generation and cost reduction, including a reduction in total remuneration costs.
- Investigate alternatives to optimize tuition revenue balancing net revenue generation and accessibility.

Operational – Capital

The Committee recognizes that taking on debt presents a risk to the University and imposes future commitments. Capital expansion is often a key ingredient to support research and academic expansion and, as such, all capital expenditures should be linked to explicit strategic priorities, and deemed mission critical. The Committee recommends that the University:

- Reassess all approved capital projects to ensure that there is a full understanding of the impacts of completing the projects.
- Limit all new projects to those that are fully funded and supported by an appropriately costed and approved business plan. This will significantly reduce the risks associated with additional debt.
- Reassess the benefits and costs of externally sourced loans that could be used to replace internal funding for specific projects and the sale or sale/leaseback of specific assets. This will help to ensure that the cash position of the University is not compromised.

Operational – Salary, Benefits and Pensions

The total cost of salary, benefits and pensions, i.e. remuneration, (including a reasonable estimate of the cost to fund the current pension deficit and post retirement benefit obligations over 20 years) is approximately \$537 million⁶ annually. Based on the projections reviewed, this cost will grow at a rate faster than the growth of new revenue. The Committee recommends that the University:

- Undertake a collaborative process to complete a full and transparent comparative review of the total compensation costs (salary plus all pre and post-retirement benefits) for each major group of employees. This will guide the development of compensation policies and decision making regarding changes to compensation.
- Undertake a collaborative process with employees focused on the redesign of current pension benefit. This will reduce the asymmetrical risk borne by the University and the uncertainty of future remuneration costs.

⁶ Made up of \$515 million of salaries, wage and employee benefits for 2010 (Appendix C) and an additional \$22 million of cost to fully fund pension obligations and post-retirement benefits (Context Item #6 – pg. 3)

- Reduce the total amount to be spent on remuneration in each year of the 2011-2013 forecast periods sufficiently to balance the operating forecasts, after taking into account any new net revenue generating activities and other cost savings initiatives. Reducing the total amount spent on remuneration should be done in an equitable manner, first, through lowering the amount spent on individual's total remuneration and, secondly, if necessary, by reductions in the number of employees. This will ensure the University remains financially viable. If actual future results are materially different than current projections, future decisions should reflect that.

Operational – General

The Committee recommends that the University:

- Invest strategically in information technology tools and expertise. This will enhance the work environment, enable better institutional data collection and decision making, establish life-long connections to our graduates and better enable and support innovative teaching and research.
- Apply the concept of excellence (referred to earlier) and implement performance monitoring to assist in defining the deliverables of all units and all levels of the University. The subsequent transparent communication of results will promote understanding and continuous improvement.
- Implement a process by which senior management will monitor new hiring and strategic appointments, not to stop hiring but to ensure that hiring supports explicit institutional priorities. Full costing of new hiring will ensure that informed decisions are made regarding the impact of each decision on the financial performance of the University.
- Continuously improve the quality of the learning environment and monitor the cost of learning by reexamining:
 - The teaching skills required in different Faculties and at different levels of the curriculum to support best practices in student learning,
 - The need and potential for cross-disciplinary and cross-faculty collaboration,
 - The ability to increase teaching partnerships with other institutions,
 - The optimal mix of tenure/tenure track faculty, teaching stream faculty, CLAs and sessional resources required to meet the pedagogical and cost imperatives of the University,
 - The extent to which different models would impact the number of courses able to be offered, and
 - The limitation of most teaching to the Fall and Winter terms and the underutilization of teaching space in the Summer.

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Terms of Reference

The purpose of the advisory committee is to provide strategic advice to the President on mitigating strategies to ensure the long-term sustainability of the University.

Short-term and long-term strategies must:

- preserve the academic and research mission
- develop fiscal strategies to address the current economic realities
- ensure that the University will be poised for action on the other side of this economic downturn

University Commitments

Commitment to:

- the core mission of academics and research in a student-centred university
- the goals of *Refining Directions*
- accessibility for students
- renewal of faculty
- strategic growth and capital development where funding sources are secured

Principles to Guide the Development of Recommendations

- **Visionary** – the aim is to build organizational capacity to preserve the academic and research mission of the University
- **Transparency** – all recommendations will be fully disclosed to the McMaster community
- **Sustainability** – all recommendations will be assessed for their short-term and long-term impact to the University
- **Holistic View** – all recommendations will be assessed for the financial and non financial impact
- **Fiscal Accountability** – the recommendations will Employ Best Practice approaches – focus on efficiency and economy
- **Stability** – recommendations will smooth the impact to avoid severe ups and downs

**President's Advisory Committee
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Committee Members

David Lazzarato - Chair
Board of Governors

Doug Barber
Board of Governors

John Berlinsky
McMaster University Faculty Association

Eric Brown
Faculty of Health Sciences

Mark Chamberlain
Board of Governors

John Connolly
Faculty of Humanities

Susan Denburg
Faculty of Health Sciences

Terry Flynn
DeGroote School of Business

Heather Johnson
CUPE 3906

Azim Kasmani
McMaster Students Union

Kostalena Michelaki
Faculty of Social Sciences

Sam Minniti
McMaster Association of Part-time Students

Fiona McNeill
Faculty of Science

Ayesha Rashid
Graduate Students Association

Matt Root
CAW Local 555

Heather Sheardown
Faculty of Engineering

Dave Tucker
The Management Group

Resources

Karen Belaire
Vice-President - Administration

Ilene Busch-Vishniac
Provost & Vice-President – Academic

Mark Haley
Asst. Vice-President - Human Resources Services

Karen Menard
Assoc. Vice-President - Institutional Research & Analysis

Lilian Scime
Asst. Vice-President – Administration

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Financial Projections 2010-2013

The financial projections below have been prepared in accordance with Generally Accepted Accounting Principles (GAAP) and include the full accrual of all costs.

The purpose of these high-level projections was to provide the Committee with directional information on the degree of variance that would occur if no other mitigating actions were taken and to focus attention on strategies that would be required to address the problem. The Committee initially reviewed three different scenarios each of which had varying assumptions and were generated in January 2009, using the final audited 2007/08 audited results as the starting point.

The version presented below and referenced in the report reflects the 'moderate' set of assumptions which can be summarized as follows:

- Operating grants are constant
- Tuition revenues increase by 5% per annum
- Other revenues increase by 3% per annum
- Investment income is 3% in 2010 and 7.5% thereafter
- Expenses increase by 5%
- Employee benefit cost assumptions continue to include annual cash pension deficit payments of approximately \$ 8 million per year
- Employee benefit cost assumptions also continue to include an annual accrual of \$20 million (incremented by 5% each year) for non pension future employee benefit costs (which are not funded)
- Only currently approved capital projects are undertaken

McMaster University Financial Pro Forma
(In \$000's) - Full Accrual all costs

	2009/10	2010/11	2011/12	2012/13
INCOME STATEMENT				
REVENUE				
Operating Grants	196,691	196,691	196,691	196,691
Research Grants & Contracts	149,176	153,652	158,261	163,009
Tuition Fees	146,327	153,643	161,326	169,392
Ancillary Sales & Services	68,330	70,380	72,492	74,667
Other Revenue	192,829	199,625	204,157	209,221
Investment Income (net)	23,858	32,203	32,681	29,732
TOTAL REVENUES	777,212	806,193	825,607	842,711
EXPENSES				
Salaries & Wages	394,303	414,018	434,719	456,454
Employee Benefits	120,823	126,865	133,208	139,868
Supplies & Services	222,965	234,113	245,819	258,110
Interest on Long-Term Debt	11,034	9,839	9,773	9,696
Amortization of Capital Assets	64,590	63,679	62,898	64,476
TOTAL EXPENSES	813,715	848,514	886,416	928,605
EXCESS OF REVENUES OVER EXPENSES	-36,503	-42,321	-60,809	-85,894

McMaster University Financial Pro Forma
(In \$000's) - Full Accrual all costs

	2009/10	2010/11	2011/12	2012/13
BALANCE SHEET				
ASSETS				
Cash and Short Term Investments	101,123	110,907	84,355	48,527
Other Current Assets	167,648	185,893	206,656	230,301
Investment in McMaster Innovation Park	13,318	13,318	13,318	13,318
Deferred Pension Asset	200,610	190,579	181,050	171,998
Capital Assets	715,297	693,444	669,983	644,945
Investments	442,303	470,236	489,076	521,795
TOTAL ASSETS	1,640,298	1,664,376	1,644,438	1,630,884
LIABILITIES & DEFERRED CONTRIBUTIONS				
Other Liabilities	735,220	766,615	780,197	810,327
Long-Term Debt	156,642	155,514	142,770	141,742
Accrued Employee Future Benefits	245,865	267,992	292,112	318,402
TOTAL LIABILITIES	1,137,726	1,190,121	1,215,079	1,270,471
NET ASSETS				
Available Expendable Resources	70,940	60,259	25,606	-16,542
Pension & Emp.Future Ben.	-69,150	-101,308	-134,957	-170,299
Externally Restricted Endowments	230,829	244,833	260,747	277,695
Net Investment in Plant, Adjusted	269,953	270,471	277,963	269,560
TOTAL NET ASSETS	502,572	474,254	429,359	360,414
TOTAL LIABILITIES AND NET ASSETS	1,640,298	1,664,376	1,644,438	1,630,884

Analysis of Available Expendable Resources	2009/10	2010/11	2011/12	2012/13
Departmental Reserves	30,751	11,875	-21,014	-74,181
Ancillary	5,571	5,571	5,571	5,571
Internal Research Accounts	9,915	9,915	9,915	9,915
Various Other Reserves	26,687	25,718	24,021	22,717
Internal Endowments	92,421	94,832	97,589	101,065
Sinking Fund	18,185	20,058	10,078	11,708
Internal Loans	-112,590	-107,710	-100,555	-93,337
TOTAL	70,940	60,259	25,606	-16,542

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Results of Actuarial Valuation For Funding Purposes					
Salaried Pension Plan 2000 (1)					
(\$ millions)	July 2000	July 2003 (2)	July 2006	July 2008	April 2009 Estimate
Market Value of Assets	966.1	719.5	912.0	1,003.8	840.0
Total Actuarial Liability	647.9	780.5	971.0	1,119.9	1,180.0
Funding excess (unfunded liability)	318.2	(61.0)	(59.0)	(116.1)	(340.0)

(1) The Salaried Pension Plan 2000 represents 97% of the Assets held for the University's 3 Registered Pension Plans. The Salaried Pension Plan (Original Plan) and the Hourly Pension Plan are 3% of the assets

(2) \$152m of assets were distributed to employees and the University under the Surplus Sharing Plan in spring 2003

(3) Actual market value of assets at April 30, 2009

(4) Estimate of the actuarial liability is calculated by increasing the July 2008 actuary calculation of \$1,120m by 5.3% where 5.3% represents 9 months of the expected annual increase of 7%. The annualized growth rate of the liability from July 2000 to July 2008 is 8.1%