UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 73 OF THE AUDIT COMMITTEE

June 16, 2004

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 16, 2004 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy
Ms Kim McLean
Mr. Richard Nunn
Mr. Roger P. Parkinson
Mr. David Oxtoby
Professor Gordon Richardson
Mr. Robert S. Weiss

Ms Catherine J. Riggall, Interim Vice-President, Business Affairs*
Ms Sheila Brown, Acting Chief Financial Officer*
Mr. Louis R. Charpentier, Secretary of the Governing Council*
Mr. Mark L. Britt, Director, Internal Audit Department**

Secretariat:

Mr. Neil Dobbs*
Ms Cristina Oke*

Regrets:

Mr. Paul E. Lindblad
Mr. Gerald A. Lokash

In Attendance:

Mr. Keith B. Bowman, Ernst & Young***
Ms Diana Brouwer, Ernst & Young***
Mr. Pierre Piché, Acting Controller*

* Absented themselves for consideration of items 5 and 9.
** Absented himself for consideration of item 5.
*** Absented themselves for consideration of items 3 and 9.

1. Report of the Previous Meeting

Report Number 72 (May 19, 2004) was approved.

THE FOLLOWING ITEMS ARE RECOMMENDED TO THE BUSINESS BOARD FOR APPROVAL.

31131

2. Audited Financial Statements for the Year ended April 30, 2004

Ms Brown offered her thanks to everyone involved in getting the April 30 financial statements to the Committee at this early date. Members of the Financial Services staff, the internal audit staff and the external auditors had all worked very hard to accomplish the task. Ms Brown reported that the external audit had been completed and the auditors had provided an unqualified audit opinion.

Ms Brown reviewed the highlights of the financial statements.

- **Included in the financial statements** were all operations under the jurisdiction of Governing Council. They included the controlled, separately incorporated subsidiaries with boards of directors: The University of Toronto Press, the Innovations Foundation, the U. of T. Asset Management Corporation, and the University of Toronto Schools. The statements did not include the federated universities, which were separately incorporated and not controlled by the Governing Council. They also did not include research administered at the affiliated teaching hospitals.
- **Key Components of Capital** (assets - liabilities) included the following.
  - Endowments included contributions designated by donors for the endowment plus reinvested earnings from those contributions, recorded at year-end market value.
  - Investment in capital assets was retained earnings invested in capital assets, which would be depreciated over time.
  - Committed capital was retained earnings internally committed for future spending for specified purposes.
  - Unrestricted capital was retained earnings that had not been restricted for any purpose. It was more commonly referred to as the surplus or deficit.

- **Significant accounting concepts**. Ms Brown reviewed the main accounting concepts used in the financial statements. She stressed that revenue was not the same as funds received and expense was not the same as funds spent. With respect to revenue, unrestricted grants and unrestricted expendable donations were recorded as revenue when received. However, restricted grants and restricted expendable donations were recorded as revenue only as they were spent for their stated purposes. Unspent restricted grants and restricted expendable donations were recorded as liabilities on the balance sheet – deferred contributions or deferred capital contributions – until they were spent.

  Donations to the endowment were not recorded as revenue at all. Rather, they were added directly to the endowment capital. Similarly, the investment earnings on the externally restricted endowments were not recorded as revenue but were added to the endowment capital.

  Expenses included the depreciation of capital projects. They also included the recording of the cost of employee future benefits in accordance with the accounting rules.

2. **Audited Financial Statements for the Year ended April 30, 2004** (Cont'd)

- **Fund accounting**. Internally, the University recorded its financial transactions using fund accounting. There were four funds:
  - Restricted funds: donations, including endowments, and research grants.
  - Capital fund: capital projects, except those for ancillary operations.
  - Ancillary operations fund, which included: residences, food and beverage services, parking, Hart House, the Real Estate Division, the U. of T. Press, the U. of T. Innovations Foundation, and the U. of T. Schools.
  - Operating fund: teaching and administrative activities supported mainly by government operating grants, student fees, and sales of supplies and services.

- **Financial results: assets, liabilities and capital**. Assets for the year ended April 30, 2004 had reached the $3-billion level for the first time. Subtracting from the assets of $3,030.5-million deferred contributions of $758.9-million and traditional liabilities of $784.6-million resulted in capital at year end of $1,487.0-million. That was an increase of $222.8-million from the previous year – the first increase in capital since 2000. The increase was primarily the outcome of excellent investment performance for the 2003-04 year, as well as the generosity of the University's benefactors. The endowment funds represented 87% of total capital and had increased by $225.4-million from the previous year-end. The sum of the other categories of capital (committed capital plus equity in capital asses minus the deficit) had essentially remained flat.

- **Financial results: revenues and expenses**. Revenues for the year had been $1,568.1-million and expenses $1,521.5-million, leaving a net income of $46.6-million before transfers – the first year of net income since 2000. However, setting aside the effect of investment income or losses, expenses over the past six years had increased at a compound rate of 9.5% per year while revenues had grown by only 7.9% per year.

- **Financial results: surplus / deficit**. From the year's net income of $46.6-million, $27.1-million of net transfers had been added back to capital. Good investment performance had allowed for net transfers that would replenish capital for the first time in four years. The result was a current-year surplus of $19.5-million after transfers.

- **Key drivers of financial health and performance**. Ms Brown displayed a diagram showing the interdependence of the key drivers of financial health and performance: enrolment growth, investment performance, endowment growth, growth in research activity and others. As an example, she noted that enrolment growth produced increased revenues, but it also resulted in a need for capital investment in facilities to accommodate the increased number of students and therefore a need for borrowing to pay part of the cost.

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

As a second example, she noted that while good investment performance in 2003-04 had brought about increased revenue, that was a volatile factor; setting aside investment income, expenses had been rising faster than revenue, leading to the need for on-going budget reductions and strategies to increase revenue.

- **Revenues by category**. Ms Brown displayed a graph showing the University's revenues from various sources over the past six years: investment income, expendable donations, sales of services (such as rents from student residences), restricted grants and contracts (primarily research grants and contracts), student fees and government grants. Over the past six years, the largest increases had been in revenue from student fees and government grants. Those increases had been driven primarily by enrolment increases, with government grants not having been increased to compensate for the effects of inflation. The outcome was that government grants had been declining steadily as a proportion of total revenue. Government operating grants had covered 39.5% of total expenses in 1997-98 but only 31.5% in 2003-04. This reflected the severe under-funding of university education in Ontario, where per-student funding was the lowest in Canada. It was interesting to note, however, that the diversity of the University's funding sources was a positive factor from the point of view of the debt-rating agencies, which did not like to see too much reliance on any one source.

- **Student fees and student aid**. Since 1998, revenue from student fees had doubled, but spending on student aid had increased by a factor of four. The number of students had increased by 33% since 1998, but the amount of student aid per student had increased by significantly more than 33%. In 1997-98, spending on student aid was about 13% of fee revenue. In the past year, spending on student aid was about 20% of revenue from student fees.

  In response to a member's question, Ms Brown said that the amount recorded as student aid expense included only a part of the guaranteed funding packages for graduate students. Funding provided in the form of teaching- and research-assistantships was reported in the line for salaries and benefits.

- **Government grants, student fee revenue and financial aid per full-time-equivalent student**. Since 1997-98, government grants per full-time-equivalent student, including one-time special grant programs, had remained essentially flat after taking inflation into account. The University had been forced to respond by increasing average fees per full-time-equivalent student by 54% and had then more than tripled aid per full-time-equivalent student. That student aid was provided both from endowment income and from operating funds.

  In response to a member's question concerning fees for students from other countries, Ms Brown said that the University had some years ago reduced fees for international students in response to a decline in their enrolment. The University had sought, by the fee reduction, to attract excellent students from abroad and to increase the diversity of its

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

student body. For 2004-05, the University had decided to commence increasing fees for international students, planning to use the increased proceeds in part to enhance recruitment efforts for excellent international students and to provide financial aid for needy international students. The previous strategy was that tuition fees for international students should be the same as the fees paid by domestic students plus the government operating funding generated by the enrolment of domestic students. (Government did not provide operating funding for non-Canadian students.) The new strategy was that tuition fees for international students should be the same as the fees paid by domestic students plus the government operating funding that would be generated by domestic students if that government funding had been at the Canadian national average.

In response to another member's question, Ms Brown said that the University's long-range budget plan projected that undergraduate enrolment would level off in 2006, with relatively small reductions or increases in the years thereafter. Graduate enrolment was a more problematic matter because Ontario Government funding for graduate students was capped, restricting any enrolment increases to very modest ones. The University was strongly advocating the removal of this cap. First, undergraduate and graduate enrolment had become unbalanced. Second, the much larger number of students now in undergraduate programs, arising from the double cohort as well as demographic factors, would very soon be seeking places in graduate and professional programs, and there were not currently enough funded places to accommodate the appropriate proportion of the larger undergraduate enrolment. Ms Riggall noted that the problem was likely to be particularly acute at this University, which currently accommodated about 30% of graduate enrolment across the Province.

In response to another question, Ms Riggall said that the incremental revenue generated by enrolment growth was pooled in an Enrolment Growth Fund and allocated to the divisions that were accommodating the growth to enable them to meet the cost of providing teaching and services to their additional students and to meet debt-service costs for the new facilities that had been, and were being, built to accommodate the added enrolment.

- **Restricted grants and contracts**. Government and other grants and contract revenue for restricted purposes were recorded as revenue only when spent. Until that time, they were recorded as liabilities – deferred contributions or deferred capital contributions. As a result, revenues from this source always matched expenses, with no gain or loss. The growth in research-grant revenue had been very significant, growing from $126.3-million in 1997-98 to $319.3-million in 2003-04. That had been the outcome of the Government of Canada's "innovation agenda," implemented in part by increases to the budgets of the three federal research granting councils, and also the outcome of the success of the University's outstanding scientists and scholars in winning a disproportionately high share of those peer-adjudicated research grants.

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

- **Donations**. Members would be aware that the University had succeeded in its Campaign goal of raising $1-billion. That sum included both pledges that had not yet been fully paid and gifts to the federated universities (Trinity, St. Michael's and Victoria), which had participated in the Campaign but which reported their donations separately on their own financial statements. The University itself had received donations – cash and gifts in kind – totaling $674.4-million for the period 1997-98 to 2003-04. Receipts for 2003-04 were $71.3-million, including $39.4-million of expendable gifts, reported as revenue, and $31.9-million directly added to the capital of the endowment.

  A member observed that the Campaign had been an extraordinary success, which had set new standards for fundraising across Canada. He added, however, that cash contributions had declined for the second straight year. Ms Riggall, Ms Brown and Mr. Piché replied that 2001-02 had marked an exceptionally successful year. The University was currently collecting the proceeds of earlier pledges and gearing up for the next campaign. That being said, the total of gifts and pledges received in 2003-04 was an impressive $120-million, indicating a continuation of the University's extraordinary success.

- **Investment earnings**. With a large endowment, the University had obligations to provide payouts to the beneficiaries of the individual endowment funds, who required them to provide financial aid, salaries for endowed professorships, and support for various programs. Investment earnings for 2003-04 were $261.4-million. Of that amount, $137.5-million was added directly to the endowment capital with the remaining $123.9-million recorded as revenue. That revenue was of three types: (a) $46.5-million used for payouts from the endowments, (b) $33.2-million of earnings on internally restricted endowment funds which was returned to the endowment capital, and (c) $44.2-million of investment earnings on expendable funds.

- **Expenses: Salaries and benefits and non-salary expenses**. Salary and benefits expense had increased from $537.4-million in 1997-98 to $907.8-million in 2003-04. That reflected in part the increased size of the faculty and staff required to teach and provide services to the University's growing enrolment. It also reflected the salary increases arrived at in negotiation with the Faculty Association and the unions as well as the growing expense for pensions, vacations and other benefits. In response to a question, Ms Brown said that the number of faculty and staff had increased by 14% since 1997-98. The increase in benefits expense included the accrual (the non-cash expense) for the cost of employee future benefits. Non-salary expenses had increased from $344.4-million in 1997-98 to $613.7-million in 2003-04. That increase had been driven primarily by the growth in research activity.

  The cash cost of salaries and benefits for 2003-04 had been $799.4-million. In addition the University had accrued an expense of $108.4-million to account for the cost of employee future benefits, as required by accounting rules. That cost included an expense that took account of the pension deficit. The University was resuming contributions of

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

the full current service cost to the pension plan as well as a special payment to deal with the deficit. Those payments, along with decent investment performance, should eliminate the pension plan deficit. The University had still to determine how it would deal with the growing liability for employee future benefits other than pensions and disability insurance. The financial statements reported not only the current-service cost for those employee future benefits but also one part of the fifteen-year amortization of the existing liability for employee future benefits at the time of the change in the accounting rules requiring the recording of that liability.

In response to a member's question, Ms Brown said that salary and benefits expense amounted to 54% of revenue in 1997-98 and 58% in 2004-05. In response to a member's question, Ms Brown said that the University did not compare this proportion to other universities; rather it compared salary levels directly. It could be misleading to compare these ratios to peer universities in the U.S. because the University of Toronto was required to teach more students than research-intensive universities in the United States and received a lower level of research funding. (This led to a discussion of accountability reporting and a proposal for a management discussion and analysis, which discussion is reported below.)

A member observed a change in the significant actuarial assumptions adopted in measuring the University's accrued benefit obligation for pension and other benefit plans: the assumed rate of compensation increase had been changed from 4.5% annually to 3.75%. Did the new assumption reflect that in the University's long-term budget plan? Ms Brown replied that it did.

- **Capital investment in infrastructure**. In 1997-98, the $43.8-million of additions to capital assets did not even match the $50.4-million depreciation expense. Beginning in 1999-2000, however, there had been a major increase in capital activity needed to provide the space for student enrolment growth and increasing research activity. The $329.3-million of additions to capital assets in 2003-04 included the purchase of the Colony Hotel for use as a student residence.

  A member asked what proportion of the additions to capital assets represented new construction and what proportion had been devoted to improving current facilities. Ms Riggall replied that the vast majority had been the new facilities required to accommodate the increased enrolment, for example student residences and teaching laboratories. About half of the new spending was for new student facilities, especially residences. The other half of the spending was for new academic buildings, and at least half of that spending was for research facilities such as the $88-million Terrence Donnelly Centre for Cellular and Biomolecular Research.

  In response to a question, Ms Riggall and Ms Brown said that the construction of new residences was informed by a policy that the University should seek to increase its residence spaces to provide accommodation for one quarter of students. With the large

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

enrolment increase, the number of residence places had fallen short of the number hoped. In addition, the University guaranteed a residence space to all first-year students who wished one. The acquisition of the former Colony Hotel was intended to enable the University to meet that commitment.

In response to another question, Ms Brown said that the financial highlights at the beginning of the Financial Report contained the disclosure of the University's deferred maintenance and capital renewal requirements, currently estimated at $329-million, including the cost of asbestos containment and renewal.

- **External borrowing**. Borrowing was required to finance the University's $1-billion capital construction program. Borrowing was therefore growing as a proportion of capital, with external borrowing of $415.1-million amounting to 27.9% of the University's capital as at April 30, 2004. External borrowing included a number of bank loans totaling $55.1-million taken out some years ago to finance individual revenue-generating projects – student residences and parking garages – as well as the $160-million series "A" senior unsecured debenture issued in 2001 and the $200-million series "B" senior unsecured debenture issued in 2003.

A member observed that the University had to date considered one third of capital as being a prudent limit for debt. The Business Board would the next day consider a proposal to increase that limit. The member asked that the Audit Committee be apprised regularly of the University's debt situation. Ms Riggall said that the administration had reviewed the definition of the borrowing limit as one third of capital and had found it to be too restrictive. The administration had used the long-range budget projections as the basis of a picture of the University's debt capacity and had concluded, first, that it should be based on a five-year, smoothed average of capital rather than on capital at any particular year end, and, second, that the limit would be within a range of 33% to 40% of capital. That conclusion had been based on a realistic, indeed pessimistic, budget projection. The proposal to borrow a further $150-million for capital purposes would leave external borrowing within the proposed 40% limit. (In addition to external borrowing, a maximum of $200-million could be borrowed for capital projects from the Expendable Funds Investment Pool.)

In response to a question, Ms Riggall said the projects to be financed were those on the University's capital plan, which set out priorities for capital projects based on the University's academic planning. In addition, it was proposed to use $30-million to finance the construction of a new Varsity Stadium, with debt-service costs to be handled by the Toronto Argonaut football team. It was anticipated that a cushion of $20-million would be retained. One possible further project would be an energy retrofit with a five-year payback period based on savings generated, for example, by installing more energy-efficient lighting and ballasts.

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

- **Endowments**. The original capital of the endowment funds was not spent. Only the investment earnings from that capital, after an adjustment to maintain the value of the endowment against erosion by inflation, could be spent for the purposes specified by the benefactors of each endowment fund. The $1.288-billion value of the endowment consisted of funds to support the following purposes: $390.7-million to support endowed chairs and professorships; $522.8-million to support student aid; $170.3-million to support academic programs and $203.9-million to support research activities. A previous category had been matching funds, which had been used by the University to match donations to the endowment. By the end of 2001-02, all of that money had been used to match donations and had been reallocated into the other categories. As at April 30, 2004, the total value of the endowment had increased by $225.4-million because of the following: $170.7-million of investment earnings, in excess of the earnings paid out; $38.7-million of endowed donations and grants; and $16-million of transfers from expendable funds.

  Good investment returns in excess of the endowment payout in such years as 1997-98 and 1999-2000 had enabled the University to re-invest a part of those earnings. Those re-invested earnings had been depleted by a combination of payouts, inflation and poor investment returns in 2000-01 to 2002-03. Fortunately, however, the inflation adjusted value of the endowment pool, taken as a whole, had been restored by the re-investment of $170.7-million in 2004-05, after the payout of $46.5-million.

  The restoration of the inflation-adjusted value of the endowment pool, plus a modest cushion, had also been made possible by a change in the payout formula. The individual endowment funds held units in the Long-Term Capital Appreciation Pool, and the payout for each unit had been reduced by 30% for 2002-03 to $6.60. Pursuant to the new payout procedure, that $6.60 payout had been increased by 2% to $6.73 per unit to compensate the unit-holder / beneficiaries of the endowed funds for inflation.

  Ms Brown stressed that while the endowment overall had regained its inflation-adjusted value, some individual endowment funds still had not done so. That was especially the case for endowments established in 2000, when units had been purchased at the high point of the equity markets.

  A member referred to the elimination of the matching-funds component in the overall endowment. What would be the source of the University's future matching funds for donations under the new O.S.O.T.F. program? Ms Brown replied that, except for donations by its faculty, staff and governors, the University would not match O.S.O.T.F. donations. The sole match would be that provided by the Government of Ontario.

- **Operating fund revenues and expenses**. Ms Brown recalled that for internal purposes, the University kept its accounts in four funds: the main operating fund, the ancillary

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

operations fund, the capital fund, and the restricted funds consisting of the endowed funds and funds for research grants and contracts.

In the operating fund, revenues for 2003-04 had been $1,037.4-million and expenses $1.034.9-million, with a net income of $2.5-million, before transfers. That favourable outcome was the first since 2000-01 and was the result of good investment performance. Setting aside the investment income of $59.3-million, operating fund expenses continued to grow faster than revenues.

In addition to the $2.5-million of net income, there were net transfers into the operating fund from the other funds, in particular from committed capital, amounting to $20.6-million, leading to a surplus on the year's operations of $23.1-million. That reduced the cumulative deficit from $33.6-million at the beginning of the 2003-04 year to $10.5-million, which represented very good news.

- **Transfers**. Ms Brown elaborated on the $20.6-million of net transfers into the operating fund. Those transfers, plus the $2.5-million of net income, had caused the reduction in the operating fund deficit.

  - $56.1-million of operating fund committed capital had been transferred into the operating fund. That represented a reduction over the previous year, when it had been necessary to increase committed capital in the operating fund by $72.2-million. In that year, the University had incurred an investment loss of $47.7-million, which was recorded as negative committed capital to be reduced over four years by transfers into committed capital from the operating fund. For 2004-05, investment loss was reduced by $21.7-million as a result of investment gains. In addition, committed capital was reduced by $97.3-million by the recording of the annual expense for the cost of employee future benefits, including pensions.

  - A net amount of $4.4-million had been transferred to the restricted funds – the endowment or other committed capital in the restricted funds.

  - Finally, $31.1-million had been transferred into the capital fund to acquire capital assets and was reflected by an increase in the University's equity in capital assets.

- **Capital by fund**. Of the University's total capital of $1.487-billion, most was accounted for the by $1.287.7-billion endowment and $190.5-million of other committed capital in the restricted funds. The capital fund had $121.6-million of capital and the ancillary operations fund had $27.9-million of capital. That was offset by a negative amount of capital in the operating fund: negative committed capital of $130.2-million and the $10.5-million operating fund deficit. The $10.5-million cumulative operating deficit was well under the 1.5% of operating fund revenue at the end of a budget plan that was the maximum cumulative operating fund deficit permitted by Governing Council policy.

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

Therefore, the University's results had come in as required at the end of the budget planning period.

A member asked about the negative amount of $140.7-million of capital in the operating fund. Ms Brown replied that much of the negative committed capital of $130.2-million was the outcome of unfunded liability for employee future benefits. The amount of those benefits (apart from pensions and disability insurance, which were funded) would increase very substantially over the years. That would take place for two reasons: first, the current service cost of unfunded employee future benefits would accumulate each year. Second, the University would continue to take into its financial statements over a fifteen year period the amount of unfunded employee future benefits in place when the accounting rules were changed. The University paid for those benefits on a pay-as-you-go basis. The growth in this overall negative amount might be offset to some extent by any growth in the expendable trust funds held by the various divisions and departments and by the amounts of unspent operating budget appropriations carried forward by the divisions and departments at the end of the fiscal year. Complete information about committed capital was recorded in note 12.

- **Conclusion: components of net income**. Net income for the University (all four funds) was $46.6-million for 2003-04, a turnaround from a net loss of $164.4-million in 2002-03. The net income was made up (a) of investment income of $123.9-million (which was that portion of investment income recorded as revenue and not that portion recorded as a direct addition to the endowment) and (b) a $77.3-million revenue shortfall, consisting of a $108.4-million expense for pension and other employee future benefits that was not specifically budgeted, offset by other income of $31.1-million.

- **Conclusion: additions to capital**. Capital increased by $222.8-million over the year. That included the net income of $46.6-million, the $137.5-million investment gain on externally restricted endowments, $31.9-million of externally restricted donations to the endowment funds, and $6.8-million of grants to the endowment by the Government of Ontario. Overall, good investment performance had resulted in capital growth in 2004, mostly reversing the $236.3-million capital reduction that had taken place in 2002-03.

The Chair thanked Ms Brown for her excellent presentation. Among the matters that arose in discussion were the following.

(a) Suggestion for the inclusion in future annual financial reports of management's discussion and analysis. Arising from the discussion of the proportion of expense for salary and benefits compared to that for other purposes, a member noted that it would be very helpful to know that ratio in comparison to benchmarks established by peer universities. That would represent only one of a number of key ratios that could usefully be compared to benchmarks. Such information would be very useful for stakeholders, and in the absence of such comparisons, it was difficult in not-for-profit organizations to know good performance from bad. Another member suggested the preparation in future years of a management discussion and analysis of the

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

financial results and of the financial prospects and risks going forward. Following the discussion of interest-rate swaps (see below) two members reiterated the desirability of a management discussion and analysis to make those matters such as those, and their associated risks, clear to readers of the financial statements.

Ms Brown replied that the University prepared a variety of information packages for different purposes for specific stakeholders. Amongst them, it did prepare annually for the Governing Council a report on key performance indicators. In response to a member's question, Ms Brown said that the reports did include comparisons of average class size. Another member proposed that the Committee receive copies of those reports as they related to financial matters. Ms Riggall reported that the Government of Ontario was in the process of reviewing accountability reporting, including appropriate indicators for such reports. The University would await the outcome of that review and then make any necessary changes to its annual performance-indicator report. A member observed that the annual report on performance indicators was a detailed one, but the information was not current. Ms. Brown replied that the data reported was a function of the varying dates of the available benchmark data. Ms Brown also observed that the University's credit-worthiness was rated by external agencies, and the University relied on data from Moody's about public universities in the United States to determine the amount of additional debt it should take on for capital purposes.

(b) Interest-rate swaps. A member referred to the University's entry into interest-rate swaps that converted floating rates of interest on certain debt to fixed rates. He noted that the outcome had been incurring a substantially higher rate of interest than both the floating interest rate and the most recent debenture issue. He said that he would like to know more of the University's hedging strategy. Ms Brown replied that the University required predictability in its borrowing costs and therefore avoided floating rates. The interest-rate swaps had been arranged with respect to bank loans taken out some years earlier to fund revenue-producing capital projects such as parking structures and student residences. The need for predictability was illustrated with respect to investment strategy. In 2000, the University had sought top returns and had had to accept risk in order to achieve them. The poor returns had shown clearly that the University could not accept financial risk. The member agreed that with fixed revenues it was important to fix the associated costs.

(c) Notes to the financial statements. In response to a member's question, Mr. Piché stated that while there had been minor changes, there had been no substantive changes to the notes to the financial statements since the Committee's review of the notes at its previous meeting.

(d) External auditors report. Invited to comment, Mr. Bowman said that the external auditors had received excellent cooperation from management, and members of the financial services staff were invariably responsive to the auditors' enquiries.

Ms Brouwer reported that there had been no changes to the audit approach or to accounting policies in the past year. She reviewed the areas of audit emphasis and significance, as discussed

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

with management and included in the document, "University of Toronto Audit Results – Year ended April 30, 2004: Report to the Audit Committee of the Governing Council."

- **Investments / Derivatives**. The auditors had spent considerable time on investments, especially investments in derivative instruments, and they were fully satisfied with respect to controls, financial statement disclosures, and conformity with accounting requirements. Management had been advised, however, of new rules that would affect the 2005 financial statements. In particular, it would be important that management have in place documentation under new accounting guidelines to determine whether it would be appropriate to continue to use hedge accounting for the University's interest-rate swaps. (The University had entered into a number of interest-rate swap contracts that had the effect of converting floating rates of interest into fixed rates.)

  A member observed that disclosure of accounting policies and documentation should be in place at the beginning of the 2004-05 fiscal year. Ms Brouwer replied that the financial statement disclosure was checked and was appropriate for the 2003-04 statements, and the University had begun the process of putting into place the documentation required under the new accounting rules. In response to a question from another member, Mr. Piché said that if the new accounting rules had been applied for 2003-04, the valuation of the University's derivative instruments would have increased by about $4-million.

- **Revenue recognition**. A substantial amount of the University's funding came in the form of grants and donations to be used for purposes specified by the grantor or donor. A significant area of audit emphasis had been assurance that the funds were used for the designated purposes and that revenue was recognized only as the funds were so used, with recognition deferred until that time. A significant change had taken place for 2003-04 in the Ontario Government's funding of SuperBuild projects, which was previously provided in advance of project construction and which was now flowed only upon completion of work. The auditors had ensured that receivables for these funds were set up appropriately pursuant to the funding agreements. The auditors concurred with the revenue-recognition accounting used in the 2004 financial statements.

- **Financial statement process**. The external auditors had reviewed the detailed manual process required to convert the information taken from the University's financial system, based on fund accounting, to make it conform with the generally accepted accounting principles required for external financial reporting. The auditors had noted no material exceptions in this process.

- **Current-year developments that required additional attention**. The University had been required by the Government of Ontario, to avoid separate financial reporting, to report on phase II of the Ontario Student Opportunity Trust Fund program based on the Government's financial year ending March 31. The auditors had also ensured appropriate documentation and disclosure concerning the new debenture issued during the 2003-04

2. Audited Financial Statements for the Year ended April 30, 2004 (Cont'd)

year. The auditors had reviewed ongoing litigation and had received confirmation from outside legal counsel to ensure the appropriateness of the disclosure of contingencies. Finally, the auditors had ensured that the estimates and judgements made in the evaluation of employee future benefit costs were within industry benchmarks.

- **New developments**. The administration had been active in addressing new accounting rules, including those concerning the valuation of financial instruments, where investments were already being recorded at market value. The auditors had discussed with the administration forthcoming requirements concerning the disclosure of guarantees and had concluded that current disclosure was appropriate. This matter arose only with respect to the University's guarantees of housing loans to faculty and staff.

Ms Brouwer referred members to the annual communication to the Committee in the "Audit Results" package concerning the auditors' independence. That letter verified that the auditors were "not aware of any relationships between the University and us that, in our professional judgement, may reasonably be thought to bear on our independence, which have occurred from May 30, 2003 to May 31, 2004." The letter also confirmed that the auditors were objective with respect to the University as defined by Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario.

Finally, Ms Brouwer referred members to the Management Letter, which stated that the external auditors, in the course of their audit, had "noted no matters involving internal control and its operation that we consider to be significant weaknesses . . . ." They had discussed with management some suggestions for "improvement related to the information technology environment and capital asset tracking."

Two members suggested that the letter of suggestions to management, as a matter of due diligence, be distributed to the Committee. Ms Brown replied that she would be pleased to do so, but she cautioned that it was very detailed and technical. The Chair asked that the letter be distributed to members when it was in final form.

The Committee met privately with the external auditors (see item 5 below), and it reviewed the report on legal services and outstanding claims, which affected note 19, Contingencies (See item 6 below). It then considered a motion to recommend the audited financial statements for approval.

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

YOUR COMMITTEE RECOMMENDS

THAT the University of Toronto audited financial statements for the fiscal year ended April 30, 2004 be approved.

3. External Auditors: Appointment for 2004 – 05

Ms Brown reported that Mr. Piché had conducted a review of the external auditors' services. He had developed a questionnaire about the quality of service provided and value added, and he had distributed the questionnaire to individuals from various areas of the University who dealt with the external auditors. That review had concluded that the University had been well served by Ernst & Young. A concern had emerged in only one specific area of the University concerning value added by the auditors, and that concern had been addressed and remedied.

Among the matters that arose in discussion were the following.

(a) Role of the Audit Committee. A member suggested that in future the Audit Committee be involved in a review of audit services.

(b) Partner rotation. In response to a member's questions, Ms Brown said that Mr. Bowman had been the Ernst & Young partner responsible for the University's audit for the past five years. In the United States, legislation (the Sarbanes-Oxley Act) required a change in auditors or audit partner at intervals of no more than five years. The U.S. National Association of College and University Business Officers (NACUBO) had considered this matter with respect to post-secondary educational institutions, had concluded that a five-year rotation would be too frequent, and had recommended a seven-year rotation. Ms Brown thought that the University should accept a new partner if Ernst & Young thought it appropriate to appoint another individual but that the University should not at this stage request a change. Not-for-profit organizations, and especially universities, were subject to special accounting principles, and it was very useful to have a highly knowledgeable individual in charge of the audit. While the University should certainly look at the matter and at the significant changes being implemented for publicly traded companies in the U.S., the University should not follow those changes if they were inappropriate. Moreover, the rules in Canada were in considerable flux, and it would not be prudent to move before the new rules had been clearly established. With respect to partner rotation, the University had worked with new partners in the past and would be prepared to do so again when that was deemed appropriate.

A member commented that the usual practice in Canada had been rotation after between five and seven years. In practice, that had meant rotation at intervals of five years, with exceptions where warranted. He agreed that private-sector rules, including those concerning partner rotation, did not necessarily apply to not-for-profit organizations, but the Committee should consider the matter. Another member agreed; the University should be a model of transparency and best practice. The Committee should therefore engage in a thoughtful review of the issue, and related issues concerning external audit, from the point of view of the University's needs and of public perception of the University. While the University should not necessarily adopt new practices required for the private sector, the Committee should nonetheless consider them carefully and make a conscious decision about adopting or not adopting them. The first member urged that this issue be considered along with a review of role of the audit committee, a requirement for certification of the financial statements by the chief executive officer and chief financial officer, and the relationship with the external auditors. In his view, the Committee could benefit from

3. External Auditors: Appointment for 2004 – 05 (Cont'd)

the Sarbanes-Oxley experience in the U.S. A third member thought it very important that the Committee be made aware of the latest developments.

The Chair agreed that these matters were the subject of considerable debate in Canada and internationally and suggested that the University should await the outcome of these deliberations before adopting any specific practices. He did think it important that the Committee receive an update on current reform in corporate governance, and he asked that the Secretary distribute the materials on the subject that had been prepared by the external auditors.

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

YOUR COMMITTEE RECOMMENDS

(a) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto for the fiscal year ending April 30, 2005;

(b) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto pension funds for the fiscal year ending June 30, 2005; and

(c) THAT the members of the University of Toronto Innovations Foundation be requested to appoint Ernst & Young LLP as the external auditors of the Foundation for the fiscal year ending April 30th, 2005 at a remuneration to be fixed by the Directors of the Foundation.

THE FOLLOWING ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

4. Business Arising from the Reports of Previous Meetings

The Chair reviewed a number of matters that had arisen at recent meetings and a number of related matters he proposed for attention at future meetings.

(a) Audit Committee Self-Assessment Questionnaire. The questionnaire, prepared by Ernst & Young and adapted for the University, had been distributed with the agenda package. The Secretary would tabulate the results for this questionnaire, and Chair and the assessors would consider steps to be taken to improve the work of the Committee. The Chair said that he would report the outcome in the fall. All input, and all constructive suggestions, would be very welcome.

(b) Interim financial statements. The Chair referred members to a letter on this subject from Ernst & Young, which was included with the materials for the meeting. On the basis of the letter and discussions with the internal auditor and the administrative assessors, the Chair had concluded that unlike public companies that produced quarterly financial statements for their

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

shareholders, such statements in the University would probably not be worth the cost and would not contribute to internal controls.

Mr. Bowman said that quarterly financial statements based on generally accepted accounting principles (GAAP) could not be produced by the University without incurring significant effort and cost, and their availability would make no major difference in decision-making. It might well be worthwhile to track particular matters on a quarterly basis, for example, the costs of employee future benefits, but management was considering means to do so other than quarterly statements based on GAAP.

Mr. Britt said that adequate controls could be provided by (a) the monitoring of budgets at the divisional and department levels, combined with (b) consolidating information from the divisions in the form of financial forecasts prepared twice per year. There was no need, from the point of view of financial controls, to produce quarterly financial statements adjusted to GAAP.

In response to questions, Ms Brown said that other Canadian universities prepared similar summarization and analyses of budget-monitoring information for interim reports. She knew of no Canadian university that produced quarterly financial statements based on GAAP. Funding and budgeting for Canadian universities was on an annual basis, and universities focused on their costs for the full year. Information was similarly provided to the credit-rating agencies on an annual basis.

A member observed that he was satisfied with this outcome, given that quarterly GAAP-adjusted statements were not required for control purposes and would not contribute to decision-making.

(c) Pension plan funding. When the Committee had, in October, reviewed the annual report on the pension plans, there had been questions about funding the plans, which had fallen into a market-value deficit. The Chair reported that the administration had brought to the Business Board, on January 19, 2004, a new Pension Funding Strategy. As reported in the Financial Highlights, that strategy called for: (a) contributions of 100% of the required employer current service cost, beginning in 2004-05, and (b) special payments of no less than $26.4-million annually in order to address the pension plan and supplemental retirement arrangement obligations. The Chair reported that he had asked the Acting Chief Financial Officer to report to the Committee on procedures for making changes to pension and other employee benefit plans and on controls over payouts from those plans. It seemed reasonable for that report to be made in the fall of 2004, along with the annual report on the pension plans.

A member advised the Committee of a recent judicial precedent concerning changes to pension plans. In order to provide plan members with the opportunity to take appropriate action, plan sponsors were required to disclose any changes being considered to pension plans as soon as those changes were contemplated. Ms Brown noted that at the University, plan changes were not unilateral; they were negotiated with the Faculty Association and with the unions that together represented almost all university employees.

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

(d) Internal Audit funding. The Chair recalled that the Internal Audit Department had been spared the usual across-the-board budget reduction for 2003-04. As at last report, Mr. Britt was awaiting news on his budget for 2004-05. The Committee had proposed budget enhancements that would enable Internal Audit to conduct an annual review of at least all units classified as high risk. Mr. Britt thanked the Committee for its past support. He observed that the budget reduction for the current year would not require that he reduce the Internal Audit staff complement, and it would therefore not significantly impede Internal Audit operations. The Chair stated his view that the University should continue to spare the Internal Audit Department from budget reductions in order to ensure that the University continued to practice good stewardship of public funds.

(e) Changes to auditing standards and procedures. The Chair recalled that, at its November 2002 meeting, the Committee had asked that Ernst & Young keep the Committee apprised on an on-going basis of all changes to auditing standards or procedures. Mr. Bowman and Ms Brouwer would be invited to comment on any such changes during their remarks on the financial statements (reported above).

(f) Organization of the administration with respect to budget matters. The Chair recalled that one year ago, the external auditors had suggested that the Vice-President, Business Affairs play a more active role in the budget process. The Chair noted that there were on-going changes in the composition of the central administration. Ms Riggall reported that she, the Vice-President and Provost, Ms Brown and the Assistant Vice-President, Planning and Budget had discussed this matter, and all were confident that they could make the existing organizational structure work well. All senior officers were committed to excellent financial controls. Everyone involved was making every effort to implement measures to ensure that the numbers used in budgeting could be translated into the financial statement numbers with minimum confusion.
Ms Riggall and Ms Brown both served on the task force dealing with budget allocations.
Mr. Charpentier added that in the searches for the Vice-President and Provost and the Vice-President, Business Affairs, the need for excellent interaction was one of the major factors considered. The Chair observed that the important point was that the Vice-President, Business Affairs, in order to oversee the financial health of the University, must have a strong role in the process of setting and monitoring the budget.

(g) New matters. The Chair said that he had asked the Acting Chief Financial Officer to report, perhaps at a meeting in the fall, on (i) the University's policy and controls with respect to approving expenses by individuals; and (ii) on administrative documentation policy and its implementation, especially policy for administrative e-mail communications.

(h) Whistle-blower policy. The Chair had asked that the Committee be provided with a copy of the University's "whistle blower" policy. Mr. Britt distributed copies of the procedure entitled "Reporting Incidents of Suspected Financial Impropriety."

5. External Auditors: Private Meeting

The Chair recalled that the Committee met at least annually with the external auditors, with no members of the administration, the Secretariat or the Internal Audit Department present. During that meeting, the external auditors were invited, as provided in the Committee's terms of reference, (a) to advise "whether adequate cooperation has been received from [the] administration and whether [the] administration has exerted any undue pressure," (b) to comment candidly on the probity and the competence of the University's senior financial officers and its Internal Audit Department; and (c) to respond to members' questions.

THE COMMITTEE MOVED *IN CAMERA*.

The Committee met privately with the external auditors.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair stated that it was agreed that there were no matters arising from this meeting that would require action.

6. Legal Services and Claims

The Chair recalled that the Committee's terms of reference charged it to review "in connection with the review of the audited financial statements, an annual report on the use of legal services and on substantial outstanding legal actions against the University in order to monitor possible risk exposures and contingent liabilities."

Ms Brown noted that the report included a summary of legal expenses incurred by each of the senior central administrative divisions and a summary of categories of the cost incurred by each of the Vice-Presidential portfolios; a summary of payments to individual law firms; and a list of outstanding legal claims against the University. In reviewing those claims, the University had concluded that it had strong legal defenses against the claim, or that it was insured against any unfavourable outcome, or both. There was, therefore, no need for disclosure of particular claims in note 19, Contingencies. In the course of discussion, Ms Brown reported that while the University had not established an in-house legal department, various departments had engaged legal personnel: two lawyers shared by the Provost's Office and the Human Resources Department to deal with employee-relations matters; one lawyer in the development area to deal with agreements with benefactors and related maters; one in the research area; and the Judicial Affairs Officer in the Office of the Governing Council.

Mr. Piché responded to an enquiry about a $1-billion claim. He noted that this was one of two related claims for $1-billion each. The first had been thrown out of court and the University was seeking a similar outcome with respect to the second. A member enquired about spending of $741,000 for legal work relating to immigration. Ms Brown said that the University worked to assist newly recruited faculty from abroad to immigrate to Canada. This was one of an extensive group of services provided to attract the most outstanding faculty. It used a firm with special expertise in the area. The Chair commented that such matters could be very cumbersome.

7. Internal Audit: Annual Report, 2003-04

Mr. Britt presented his annual report.

- **Staff complement, audit hours, and reviews completed**. Staff complement during the year was 7.3 full-time equivalent compared to the planned staff of eight. This shortfall had cost 900 hours of audit time. While the Department had returned to full complement in March, an audit manager had accepted a position in another University department, and Mr. Britt was recruiting a replacement. Because of this shortfall and because of the need to devote substantial time to special audits, ten of twenty-four planned department audits had been completed, with the remaining fourteen in progress as at year end. The Department had completed: two cycles of continuous auditing with two more in progress; six special reviews with two in progress; and four follow-up reviews with four more in progress. In addition, the Department had assisted the external auditors with their reviews of the annual financial statements, the enrolment report to the Government, Government-funded capital spending projects, and the Government-funded Ontario Student Assistance / Bursary programs.

  The Department also provided internal audit services to the University of Toronto Asset Management Corporation (UTAM) on a cost-recovery basis, with six-tenths of an auditor's time being devoted to that work, along with time provided by Mr. Britt and the Department's systems auditor. The Department had satisfied all of the requirements of the UTAM Audit and Compliance Committee.

- **Administrative accountability reports**. During departmental reviews, internal auditors verified compliance with the requirement that all individuals with financial-management responsibility complete an annual accountability report. There had been a significant increase in the proportion of non-compliance in 2003-04. However, of the 44 reports not completed by faculty members, 30 were from faculty members in a single department of the Faculty of Medicine, where the faculty members were located in the various teaching hospitals. While the cross-appointed faculty members were not University employees, they did hold research grants administered by the University. They were apparently unaware that they were required to complete the accountability reports.

- **Audit findings and residual risks**. Many of the residual risks summarized on table 3 of Mr. Britt's report were the same as those reported to management and to the Committee in previous years and were a reflection of the University's decentralized administrative environment. The area of greatest residual risk was that classified as external environmental risk. One subtype of this risk was financial reporting risk, which involved expenditures and financial reporting arising from research grants. A second subtype was taxation risk, which involved payment by invoice to individuals where an apparent employment relationship existed. Mr. Britt noted that the University was receiving more frequent visits from review teams for the federal research granting councils and from the Canada Revenue Agency, and the internal audit reviews were noting matters that would be of interest to the external reviewers. The Internal Audit Department's

7. Internal Audit: Annual Report, 2003-04 (Cont'd)

recommendations to the heads of budget units to deal with these matters had, however, been accepted and had been or were being implemented.

- **Internal Audit website**. The Department had rolled out its new web site, giving members of the Department a real sense of accomplishment. Two features were still being developed: the on-line risk assessment survey for budget units and an internal-control self-assessment survey, where administrators could on a confidential basis assess their own control environment and receive e-mailed feed back on steps they could take to improve that environment. Mr. Britt anticipated that those features would be available in the fall.

A member suggested that the Committee request follow-up reports with respect to the administrative accountability reports and the report on residual risks. With respect to the accountability reporting process, the Committee should hear from the administration what would be done differently to communicate the need for appropriate faculty and staff to complete the reports and what consequences would follow for individuals who failed to comply. With respect to the residual risks, the Committee should hear from the senior administration what steps were being taken to deal with the risks. The Chair agreed that the rate of non-compliance with the requirement for accountability reports, at least among the units that had been reviewed by Internal Audit in 2003-04, was a serious matter.

Ms Brown said that the new Vice-President and Provost was very interested to accountability reporting – including both financial and other elements. She anticipated a strong message from Professor Goel to faculty with respect to the importance of completing the financial accountability reports.

THE COMMITTEE MOVED *IN CAMERA*.

Mr. Britt reported on the Internal Audit Department's special reviews.

THE COMMITTEE CONCLUDED ITS *IN CAMERA* SESSION.

8. Internal Audit: Audit Plan, 2004-05

Mr. Britt presented the Internal Audit plan for 2004-05. The plan for reviews for 2004-05 was based on the Department's risk assessment database, requests from divisions, and general learning from previous work. The plan took into account the objective of more frequent reviews for high-risk and moderate-risk units.

9. Internal Auditor: Private Meeting

The Chair recalled that the Committee met at least annually with the internal auditor, with no members of the administration, the Secretariat or the external auditors present. During that meeting, Mr. Britt was asked to state, pursuant to item 6 of the Committee's Terms of Reference,

9. Internal Auditor: Private Meeting (Cont'd)

"whether adequate cooperation has been received from management and whether management has exerted any undue pressure." Mr. Britt was also invited to bring to the attention of the Audit Committee any other matters he deemed appropriate.

THE COMMITTEE MOVED *IN CAMERA*.

The Committee met privately with the internal auditor.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair stated that it was agreed that there were no matters arising from this meeting that would require action.

10. Report of the Administration

Ms Riggall, Ms Brown, Mr. Charpentier and Mr. Britt stated that there were no other matters that should be drawn to the attention of the Audit Committee at this time.

11. Date of Next Meeting

The Chair reminded members that the next regular meeting was scheduled for Wednesday, October 27, 2004 at 4:00 p.m.. The Committee's schedule for 2004-05 would be distributed over the summer.

12. Other Business: Chair's Remarks

The Chair thanked Ms Brown, Ms Riggall, Mr. Piché and their colleagues for their outstanding work in completing the audited financial statements so soon after the end of the fiscal year.

The Chair thanked members for their service over the past year. He offered particular thanks to two members who were concluding their terms on the Committee. Ms Kim McLean had served on the Audit Committee for two years and would continue to serve on the Business Board in 2004-05. Mr. Robert Weiss, long-time member and past-Chair of the Committee had kindly agreed to serve on the Committee for one further year during the transition year of the new Chair. Mr. Weiss would continue to serve on the Governing Council, the Executive Committee and the Business Board. Mr. Weiss stated that it had been a privilege and pleasure to serve on the Audit Committee.

The meeting adjourned at 7:10 p.m.

Secretary	Chair

July 29, 2004