ATTACHMENT
CONFIDENTIAL

UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 76 OF THE AUDIT COMMITTEE

May 17, 2005

To the Business Board,
University of Toronto.

Your Committee reports that it met on Tuesday, May 17, 2005 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)*
Mr. Gerald A. Lokash
Mr. Richard Nunn*
Mr. David Oxtoby
Mr. Roger P. Parkinson
Mr. Christopher Sparks
Mr. Mark Weisdorf

Ms Catherine J. Riggall,
Vice-President, Business Affairs

Ms Sheila Brown, 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:

Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. Joseph Mapa
Professor Gordon Richardson
Mr. W. David Wilson

In Attendance:

Ms Jacqueline Orange, member, Governing Council and Chair, Business Board
Ms Diana Brouwer, Ernst & Young
Mr. Eric Fleming, Director, Risk Management and Insurance
Mr. John Lyon, Managing Director, Investment Strategy, University of Toronto
Asset Management Corporation**
Mr. Pierre Piché, Controller and Director of Financial Services
Ms Martha Tory, Ernst & Young

* Because of a prior commitment, Mr. Myhal left the meeting following the consideration of item 8, and Mr. Nunn assumed the Chair.
** In attendance for item 3.

ALL ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

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REPORT NUMBER 76 OF THE AUDIT COMMITTEE - May 17, 2005

1. Report of the Previous Meeting

Report Number 75 was corrected on page 14. The final sentence of discussion item (a), which dealt with Ernst & Young's consulting work for the University was corrected to read, "It [the University] did not seek rebates where there was a significant risk that they might be rolled back by the Canada Revenue Agency." Report Number 75 (November 24, 2004), as corrected, was approved.

2. Business Arising from the Report of the Previous Meeting

(a) External Auditors' Engagement Letter, Audit Plan and Audit Fees

A member referred to the discussion, on page 12 of the Report, of the level of materiality for the audit. Ms Brouwer had advised the Committee that "the auditors would regard an amount greater than $15 million, which represented approximately 1% of the University's total revenues in fiscal 2003-04, as material. The final determination of items to be regarded as material would also be affected by whether an item was sensitive and whether it was of a routine nature." The member observed that while a matter involving $10-million, for example, might appropriately be regarded as immaterial according to generally accepted auditing standards, it was still a significant amount that might well be of importance and interest to the Committee. Ms Tory said that an "over / under" sheet was prepared in the course of the audit and provided to senior officers. While there was no external requirement to do so, that information could certainly be shared with the Committee, if it wished. If the auditors concluded that the matter was a significant one, they would in any event draw it to the Committee's attention.

(b) Other Matters

In response to the Chair's question, the Secretary reported that there were a number of matters of business that had arisen at the previous meeting that would require action,* but none of those matters was ready to come forward at this meeting.

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* There were three matters that had arisen on November 24, 2004. First, the Assistant Vice-President, Technology Transfer was asked to provide members with copies of the Manley review of the Innovations Foundation (see page 2). Second, in connection with the Financial Report on Capital Projects, the Chair asked that the Committee be provided with reports on the University's borrowing for capital projects, so long as those reports already existed or could be generated without the investment of too much time (see page 10). Third, the administration was asked to consider the development of a policy on the use of the external auditors for assignments other than the financial statement audits (see page 14).

3. University of Toronto Asset Management Corporation: Financial Statements, 2005

The Chair observed that the financial statements of the University of Toronto Asset Management Corporation (UTAM) had been reviewed by the external auditors (Ernst & Young were external auditors for both the University and UTAM) and had received a clean audit opinion.

Mr. Lyon recalled that UTAM had been established in April 2000. It currently had a staff of twelve, five of whom were Certified Financial Analysts and two others of whom were progressing towards achievement of that certification. UTAM managed the University's pension funds, its Long-Term Capital Appreciation Pool (L.T.CAP - the investment vehicle for most of the endowment funds and for the restricted fund established in support of the Supplemental Retirement Arrangement), and its Expendable Funds Investment Pool (EFIP). Total assets under management amounted to $4.3-billion. Between 75% and 80% of the assets were managed by external investment managers selected by UTAM, with the remainder in fixed-income investments managed by a UTAM staff member.

Mr. Lyon said that he viewed the financial statements as those of a cost centre of the University. UTAM earned no significant revenue apart from its recovery of its costs from the University. Expenses consisted primarily of salaries, premises-lease costs, and the software and services used in the management of the portfolios. The significant changes in the balance sheet were simply a reflection of differences in the timing of the receipt of expense reimbursement from the University. A difference of a few weeks at year-end had caused those changes. In 2004, there had been a change to smooth the cash flows to UTAM. The University had begun to supply UTAM's expense reimbursement quarterly in advance rather than, as previously, on an as-needed basis.

With respect to the statement of expenses and recoveries, Mr. Lyon said that the major change in 2004 was the reorganization charges, amounting to nearly $1-million. The charges dealt with key staffing changes, with three Managing Directors leaving the organization and one new one (Mr. Lyon) joining it. The reorganization was the outcome of a plan to streamline operations. In the first quarter of 2005, two other Managing Directors had left the organization, and two additional analysts had been hired. Apart from the reorganization charges, costs had increased by a very modest 1%.

Mr. Lyon reported that in spite of the extensive changes in personnel, which had not surprisingly caused some turmoil in the organization, its major initiatives were generally on track. One key initiative was the revitalization of the Private Markets program. While that program had been in place since the beginning of UTAM, it had not until recently gained a great deal of traction. UTAM management had in the fall of 2004 taken to its Board a long-term plan to commit some $720-million to investment in private-equity funds and in real-asset funds, and implementation of that plan would continue in a disciplined way in the coming year. A second key initiative concerned hedge-fund investments. UTAM had moved from investment in individual hedge funds to funds of funds. UTAM previously had investments in between 10 and

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

12 individual funds. With the move to funds of funds, this investment area would be diversified across over 100 managers. While the use of funds of funds did involve some extra costs, the increase in diversification and management expertise was well worth that cost. A final initiative was the implementation of the initial stages of an alpha-transport program. The objective of that program was to separate the management of assets designed to obtain overall market returns (or beta) from value added above general market returns (or alpha), with the above-market returns sought from active management. UTAM was beginning to implement that strategy with a portion of its U.S. equity investments, and it was anticipated that it would be fully implemented in about two months. There had been some time slippage in the implementation of the program owing to the personnel changes, but Mr. Lyon anticipated that it would soon be in place and operational.

Mr. Lyon commented on the UTAM Annual Report. Consistent with the organizational changes, the annual report had been streamlined. The UTAM Board and its Audit and Compliance Committee, of course, received much more detailed information on a regular basis, with additional information provided to the University as it was required.

Mr. Lyon reported that the three funds being managed by UTAM - the pension fund, the L.T.CAP, and the expendable pool - had all outperformed their benchmarks. The performance of the pension fund and the L.T.CAP was also measured against a universe of peer funds, and both had for the 2004 year placed in the first quartile of the fund ranking. While it would be very difficult to maintain first-quartile ranking consistently over time, experience had shown that funds that were able to maintain at least a second quartile ranking over time provided top quartile performance in the long run.

Among the matters that arose in discussion were the following.

(a) Peer comparison ranking. A member asked why, with the overall performance of the pension fund for the 2004 year ranking in the 18th percentile, all individual asset classes apart from fixed income had ranked significantly lower. (Fixed income had ranked in the 2nd percentile.) In the L.T.CAP, the three year performance had ranked only the 67th percentile, while the performance of each asset class had ranked substantially higher. Mr. Lyon and Ms Riggall replied that the apparent discrepancies were explained by three factors. First, total fund performance was strongly affected by the mix of asset categories. UTAM's asset mix was more heavily weighted to equities than that of the average fund, adding to the high ranking in 2004, when the equity markets had performed very well, and taking away from fund ranking for the three years ended December 31, 2004, which included the 2002 year and the first quarter of 2003, when the equity markets had performed very poorly. Second, while the comparison was made to a peer universe, there were substantial differences among the peer groups, with each having a different composition of participants. Third, in order to provide an appropriate comparison of the work of the fund managers, the percentile rankings of the U.S. equity and international (non-North-American) equities was reported before the effect of currency hedging.

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

Overall fund performance and ranking had, however, been affected substantially by hedging. For example, UTAM's hedging program had been of great benefit in 2004 when the value of the U.S. dollar had declined substantially against the Canadian dollar, causing a considerable decline in the value of U.S. dollar investments that were not hedged. Fourth, there was a very significant dispersion of the results in the fixed income category in 2004, when the UTAM portfolios had enjoyed exceptionally high returns owing to their significant holdings in real-return bonds, which had performed very well in recent years.

(b) Separation of market returns from value added by active management. Mr. Lyon responded to a member's request for an elaboration of UTAM's alpha-transport strategy. Usually, an investor engaged a portfolio manager who would try to outperform the market for the asset class. That manager was paid a fee, for example 75 basis points (100 basis points = 1%), on the total amount of money under management. It was, however, possible to obtain the market return for that asset class much less expensively through synthetic investments such as market-index futures. An investment program of that nature would cost only three or four basis points. Because futures investments were contracts, they did not tie up the full amount of capital. It would therefore be possible to place the remaining capital with another manager, perhaps in an entirely different asset class, to generate added value. Mr. Lyon stressed that the combination of investments would be achieved without the use of leverage or borrowed funds.

(c) UTAM reorganization. In response to members' questions about the cost of the reorganization, Mr. Lyon said that the 2004 costs had arisen from severance arrangements and a related cost for one new senior staff member. These arrangement were all consistent with market practice. There would be a reorganization charge on the 2005 financial statements as well because of the departure of another senior officer. Upon completion of the reorganization costs, the on-going, base budget for UTAM should be less than before the reorganization.

(d) Private equity program: benchmarking. In response to a member's question, Mr. Lyon said that the ultimate benchmark for the private-markets program would be the return on the Standard and Poor's 500 Index plus 5%. It was not, however, possible to apply that benchmark immediately. The private-markets program was a young one, with a substantial amount of money awaiting assignment to appropriate managers, and with those managers drawing down their committed monies over a significant period of time as they identified investment opportunities. As the money was invested, it also took a significant amount of time for the private-market investment to mature and provide a return.

(e) Private-equity program: valuation of investments. In response to a member's question, Mr. Lyon assured the Committee that the valuation of private-equity investments was consistent with Canadian Generally Accepted Accounting Principles (GAAP) for fair market value. UTAM did not make direct private investments but invested in externally managed funds. UTAM typically relied on the valuations provided by the general partners of those funds. It did exercise

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

due diligence to ensure that the funds were carrying out appropriate procedures to value their investments properly. A member, who chaired the Research, Benchmarking and Standards Committee of the Institutional Limited Partners Association, commented on the guidelines for fair market valuation that had been proposed by the Private Equity Industry Guidelines Group, which guidelines, he anticipated, would come to be adopted globally. He concurred that returns on private-equity investments took time, with the returns ideally described by a "J" curve.

(f) Private equity program: evaluation of managers. A member observed that performance of private equity investments tended to vary depending on the year the investment was made. He asked whether UTAM had developed a system for comparing performance over vintage years. Mr. Lyon replied that UTAM monitored the performance of its private-markets investments by vintage year, but it did not yet have access to a database to compare to other funds on an on-going basis. With public-market securities, UTAM measured performance over four-year rolling periods.

(g) Responsibility for asset mix decisions. The Chair recalled that responsibility for asset-mix decisions had recently been clarified, and he requested assurance that UTAM understood that those decisions were its responsibility. He asked whether asset-mix adjustments had been made in the light of the recently revised investment policies setting out new return expectations and risk tolerances. He also asked how frequently asset-mix changes were considered in the normal course of events. Mr. Lyon replied that the statement of investment objectives in the revised investment policies had not differed in substance from the previous policies, except that the objectives were stated in terms of a real (after-inflation) return rather than nominal return. The objectives and risk tolerances of both the pension fund and the L.T.CAP were now aligned, and the two funds were managed in a very similar manner. The policy asset mix was revisited annually in consultation with the University's Vice-President, Business Affairs and its Chief Financial Officer. In some years, the asset-mix review was accompanied by an extensive liability study. The policy asset mix was approved by the UTAM Board. Management reviewed the actual asset mix on an on-going basis. Rebalancing took place occasionally, especially with the recent, on-going movement of money into private-market investments. The primary reason for the difference in the asset mix of the pension fund and the L.T.CAP was the foreign content limitation on the pension fund. If the removal of that limit announced in the federal Budget was in fact implemented, UTAM would of course revisit the policy asset mix.

At a member's request, Ms Brown reviewed the division of responsibility between the University and UTAM with respect to asset mix. The Business Board, on the recommendation of the Vice-President, Business Affairs, was responsible for an annual review and approval of the University Funds Investment Policy and the University of Toronto Pension Master Trust Investment Policy, which set out the funds' return expectation (currently a 4% real, or after-inflation, annual return averaged over four years) and risk tolerance (currently a maximum standard deviation of 10% over any ten-year period). The UTAM Board was then responsible for approving the asset mix

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

appropriate to obtain the return objective within the stated risk tolerance. There was one added responsibility imposed by the Ontario Pension Benefits Act. For the pension fund, the Business Board also received the UTAM investment policy, and it approved the combination of the two policies and the service agreement between the University and UTAM, which together contained all of the elements of the statement of investment policy and goals required by the Act.

(h) Benchmarking performance and costs relative to those of other universities. Ms Orange noted that the Business Board was paying increasing attention to comparisons between the University of Toronto and peer institutions. For example, at its recent meeting it had received a first report on the cost of capital projects of various types compared to those built at other universities. On the academic side, the Governing Council was comparing this University's performance to peers using a set of established performance measures. Were data available comparing the performance and cost of UTAM to that of, for example, the pension and endowment funds of the other G10 universities?

Ms Brown replied that comparisons with other universities were available. The Canadian Association of University Business Officers (CAUBO) completed an annual survey and published the returns and asset mixes of university endowment funds in Canada. The U.S. National Association of University Business Officers (NACUBO) collected and published the returns earned by several hundred universities. The University of Toronto focused its attention on the comparison of its investment performance with that of other public universities.

Mr. Lyon and Ms Brown stressed, however, that it was important to be cautious in making comparisons. With respect to costs, Mr. Lyon said that cost varied depending on asset class. For example, UTAM allocated 20% of its funds to private-market investments (private equity and real assets), which required the full-time work of two analysts as well as 30% to 40% of his time. That compared to the investment of over 40% of the funds in fixed-income investments which required the work of only two people. It was anticipated, however, that the private-market investments would provide much higher returns. There were other variables. For example, while the overall costs of an investment management corporation might appear to be higher than the costs of other universities, most of those other universities engaged external consultants to perform the work completed in-house by UTAM. With respect to performance, Ms Brown stressed that it was important to take risk tolerance into account in making comparisons. A lower tolerance for risk would reduce long-term results. It was also important to make comparisons over the long term. Each year, some universities' funds appeared to perform particularly well, for example funds that concentrated on fixed-income securities during a bear market for equities, but those funds often did not do as well in the long term.

A member urged that the administration provide the comparative data relative to other institutions. While its was entirely appropriate to point out the necessary caveats in making comparisons, the data could be provided with explanations for anomalies. Stakeholders did wish to look at performance compared to peers and it was entirely appropriate to provide the most transparent information possible.

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

(i) Audit Committee review of the UTAM financial statements. The Chair said that the public release of the UTAM financial statements had for the past three years been delayed pending their review by the Audit Committee. The remainder of the annual report including the report on investment returns, was released publicly as soon as it was forwarded to the Business Board. That was important to provide timely reporting to interested parties such as members of the pension plan and members of the university who relied on distributions from the endowment fund. UTAM was now registered with the Ontario Securities Commission, and the annual report had to be filed with the Commission by March 31 each year. However, the delay of the public release of the December 31 financial statements until late May had caused some expressions of concern. In response to a question, the Secretary reported that the President of the Faculty Association had asked about investment-management costs and had expressed concern about the delay in the release of the financial statements. The Chair asked whether it was necessary to delay the release of the financial statements. The assets of the pension funds were reported on separate financial statements and the other University assets managed by UTAM were included in the University's financial statements. The UTAM financial statements dealt only with UTAM's internal operations. They were reviewed by the external auditors and the UTAM Audit and Compliance Committee, and they were approved by the UTAM Board. The amounts on the statements were not material to the University's financial statements. They did not deal with investment performance. He therefore proposed that the statements be released without delay. That was all the more the case because the Committee's scheduled did not include a meeting between the December 31 year-end and late May.

In response to questions, the Secretary said that UTAM was classified as an "incorporated business ancillary operation," like the University of Toronto Press and the Innovations Foundation. Unlike the situation with the other ancillary operations, the Business Board had not asked the Audit Committee to monitor the substantive work of UTAM. Given the significance of the amounts involved to the University's operating budget, the Business Board had retained the responsibility for monitoring investment performance. It had received, discussed, and accepted UTAM's annual report, subject to the Audit Committee's review of the financial statements. UTAM's full annual report had traditionally been distributed to the Audit Committee, but only for background information. The Audit Committee's role was, therefore, a limited one: to satisfy itself with respect to the financial statements. The Audit Committee was asked to consider UTAM's financial statements and, if appropriate, to recommend them to the Business Board for "acceptance." The financial statements had been reviewed by the UTAM Audit and Compliance Committee and had been approved by the UTAM Board. Ms Brown noted that the UTAM financial results were consolidated into the University's financial statements.

In discussion, some members supported the release of the financial statements before the Committee's review of them. Others thought that such release would be inappropriate. If the Committee was responsible to review and accept the statements, it should do so before their public release. One suggestion was that the Committee meet earlier in the calendar year, noting

3. University of Toronto Asset Management Corporation: Financial Statements, 2005 (Cont'd)

that there was a reserve date in March in any event. A second suggestion was, because the amounts involved in UTAM's internal operations were small, the Committee ask that it not be responsible to accept the statements, but perhaps only receive them for information. The statements had been reviewed by the very able people on UTAM's Audit and Compliance Committee and Board. It was unlikely that a second review by the University's Audit Committee would add much value.

Ms Tory stated that the auditors had signed off on the statements upon their approval by the UTAM Board, and they understood the statements to be approved and issued as of that date.

Ms Riggall undertook to consult further about the matter and to bring a recommendation to a later meeting of the Committee for next implementation with respect to the 2005 financial statements.

In the course of discussion, Ms Brown noted that the Committee had also in a previous year reviewed a report on financial controls over the University's investment assets, and the administration planned to bring forward another such report to a future meeting, either the June 2005 meeting or the first meeting of the new academic year. A member observed that a review of financial controls would be more germane to carrying out the Committee's fiduciary responsibility than a review of audited financial statements that were limited to UTAM's internal operations. A review of controls, combined with a review of the reporting of the investment assets and income on the University's financial statements, would represent a satisfactory discharge of the Committee's responsibility.

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

YOUR COMMITTEE ACCEPTED

The audited financial statements of the University of Toronto Asset Management Corporation, December 31, 2004.

The Chair observed that investment returns in the past two years represented a dramatic turnaround, and he asked Mr. Lyon to convey the Committee's compliments to the Board, management and staff of UTAM.

4. Endowment Funds: Annual Financial Report - Template

Ms Brown said that the document before the Committee was the template for a new annual report on the University's endowment funds. It was intended for benefactors who had contributed to the endowment, for the Governing Council, and for other interested parties. The University received many questions about the endowment. While most donors to the endowment

4. Endowment Funds: Annual Financial Report – Template (Cont'd)

were satisfied with the current two-page report that was distributed annually, some were not. A great deal of information about the endowment was currently available in a variety of sources. The new document would bring all of the key information together in a single report. The report would also include financial statements taken from information in the University's financial statements. The objective was enhanced transparency and accountability. The template for the new report was based on April 30, 2004 data. The objective was that the first annual report would be based on April 30, 2005 data. Like all reports including financial statements, it would be brought initially to the Audit Committee. It would then be presented to the Business Board. Ideally, it would be presented at the same time as the audited financial statements. It was, however, not at all certain that the 2005 annual report could be prepared and presented at the same time. Ms Brown planned to present the report to the Committee at its first meeting in the fall; however, if it were to prove possible to do so, she would present it on June 22, 2005. At this time, Ms Brown sought the Committee's advice on the template to assist her in making the report as comprehensive and clear as possible. She would welcome member's advice at this time after the meeting. Ms Brown noted that it was not intended to produce a large quantity of printed copies. Rather, the report would be made available on the University's web site for official documents, and copies would be sent on request to, for example, donors to the endowment.

A member said that production of the report was an excellent idea. He suggested that the report include in a prominent place information on the support provided by the endowment. The report should make clear the limited amount of the payout provided by the endowment income. Similarly, the report should show the amount of endowment and endowment-payout per student. While it appeared to some outside observers that the University, with its $1.3-billion endowment, should have no financial problems, a payout of less than four percent or $800 per student provided limited support. In addition, the report should provide comparisons with the endowment capital and payout of all peer universities – public and private. The University sought to be among the top public teaching and research universities in the world and then eventually to compete with the top private universities. It was important to make it clear that the University had a long way to go in building its endowment if it is to achieve its aspirations. Another member agreed, noting that not only external but some internal observers were under misapprehensions about the level of support that could be provided by the endowment.
Ms Brown agreed that the point was a helpful one. The comparisons with peer institutions would help to establish the University's aims for fundraising, especially in the long term.

5. Audited Financial Statements for the Year Ended April 30, 2005: Draft Notes

Ms Brown said that the Committee would be asked to endorse the notes as part of the audited financial statements, presented at the June meeting. At this time, the statements were presented for members' review and advice. In the draft notes now before the Committee, the changes from the previous year were highlighted.

Mr. Piché said that the changes to the draft notes had been reviewed and approved by the external auditors. He outlined the major changes.

5. Audited Financial Statements for the Year Ended April 30, 2005: Draft Notes (Cont'd)

- **Capital and net assets**. The term "capital" used in the University's financial statements for the past few years, would be replaced with the previously used term, "net assets." The latter term was more commonly used in the financial statements of other universities and was preferred by the Canadian Institute of Chartered Accountants. Using the term "net assets" would eliminate some confusion within the University that had been caused by the use of the term "capital." Ms Tory confirmed that the term "net assets" was a more standard one.

  A member referred to the second paragraph of note 1, which stated the University's financial statements included "assets, liabilities, net assets, revenues, expenses and other transaction of all of the operations and organizations under the jurisdiction of the Governing Council," but did not include the "assets, liabilities, net assets and operations" of the federated universities and other related organizations. He suggested that the addition of the term "net assets" in these sentences did not add value and should be eliminated. Mr. Piché agreed.

- **Public sector salary disclosure**. The University and other Ontario public-sector bodies would no longer be required to publish the salaries of employees above $100,000 per year as part of the financial statements. The Ontario Government had determined that it was adequate for the list to be published on a public website.

- **Note 2(b), Derivative financial instruments**. The wording of the notes had been changed to clarify the accounting for interest rate swaps used to fix interest rate expense on certain loans for the long term. There was no change in the swaps or in the hedge accounting used in the financial statements. The sole change was the clarification of the note disclosure. For all other derivative financial instruments, which were used as a substitute for more traditional investments, their value was reported as approximately equal to the fair value of the underlying financial instruments.

  A member suggested that the note be amended to specify the lines on the financial statements where the particular items were recorded, in particular the lines on the statement of revenue and expense where there were any gains, losses, revenue or expenses that had been included in the determination of income.

- **Note 2(d) and 3, Employee benefit plans**. The University provided defined-benefit pension plans and other retirement / post-retirement benefit plans, primarily medical benefits and dental care. The note had been amended, pursuant to the Canadian Institute of Chartered Accountants (C.I.C.A.) Handbook revised section 3461, to provide more information about the University's accounting for its pension plan assets and its liability for all of the retirement / post-retirement benefit plans. Pension plan assets were reported at fair value. The cost of benefits earned was charged to income annually. Past service

5. Audited Financial Statements for the Year Ended April 30, 2005: Draft Notes

costs, experience costs and the cost of any changes to actuarial assumptions were amortized over the average remaining service life of active employees, which was currently fourteen years. Again, there was no change in accounting but simply more information and explanation provided in the note.

Also, pursuant to C.I.C.A. Handbook section 3461, the revised note 3, paragraph 3 was intended to provide more clarity. It provided information about the timing of the actuarial valuations of the pension plans. The table on the top of page 16 showed the $241.8-million pension-plans deficit as at April 30, 2004. The additional disclosure in the table showed the derivation of the amount of the accrued liability on the balance sheet. The difference arose from actuarial losses deriving from changes in the annual actuarial valuations and the transition from accounting for assets at the smoothed market value to fair market value, with the difference being amortized over fourteen years.

The table at the bottom of page 16 showed the reduction in the discount rate for the accrued benefit obligation from 6.25% to 5.75%. The reduction was required to conform to the requirement that the discount rate match the market rates for high-quality corporate bonds. The outcome was an increase in the accrued benefit obligation of $161.8-million.

- **Note 4, Investments**. Additional sentences on page 19 provided more information on the operation of the swap agreements the University used to fix a long-term rate of interest to replace its agreements to pay floating rates on certain debt obligations.

  A member asked about a line in the table on the bottom of page 17, showing the fair values of the various categories of the University's investments. The line in question showed the "derivative related net receivable (payable)." Mr. Piché referred to the table on page 19, which showed both the notional value and the fair value of various derivative instruments, including forward contracts on foreign currencies and U.S. equity index futures contracts.

- **Note 14, Ontario Student Opportunity Trust Fund**. In 2003-04, the University had been required for the first time to account for its endowments under the Ontario Student Opportunity Trust Fund (O.S.O.T.F.) in a note to its audited financial statements. For the 2004-05 statements, the note had been enlarged to accommodate the provision of comparative figures.

6. Risk Assessment Profile, 2005

The Chair noted that the Audit Committee terms of reference called upon the Committee to review "an annual management report on significant business, financial and regulatory risks and [to] monitor the University's processes for identifying and controlling those risks. In carrying out this responsibility, the Committee focuses primarily on the adequacy of key controls

6. Risk Assessment Profile, 2005 (Cont'd)

over those vital risks considered to be, currently or in the future, more significant and likely to occur, [and] meets with management and the internal or external auditors to come to a fuller understanding and better assessment of management's response to controlling important risk situations." The Committee "reports any concerns to the University's senior officer reporting to the President responsible for financial matters, to the President, or to the Business Board, as appropriate."

Ms Brown, presented the key points in the risk-assessment profile for 2005. Her presentation and the Committee's discussion are recorded in the confidential appendix to this report.

7. Risk Management and Insurance: Annual Report, 2004

Ms Brown recalled that the Annual Report on Risk Management and Insurance had previously been submitted directly to the Business Board, but it had for the past four years been presented first to the Audit Committee. The report was presented at the same meeting as the annual risk assessment profile. For this report, "risk management" referred to the risk managed through the University's insurance program. The report had changed from that presented in recent years, and it included more graphical representation of the data. The objective of the changes had been to improve disclosure and transparency, and Ms Brown would welcome comments and suggestions. The Chair thanked Ms Brown and Mr. Fleming for the improvements to the report, which were well done.

Mr. Fleming said that the previous year had seen some good news. The University's claims experience had been relatively benign, both with respect to claims on external insurance and on the self-insurance reserve. Losses had been well below average. On the other hand, the University's premium costs had increased by 30% for the coverage provided by the Canadian Universities Reciprocal Insurance Exchange (CURIE). This was the third consecutive year of large increases. The cost of coverage in 2002 had been $800,000. That had increased to $1.1-million in 2003 and $1.5-million in 2004. In addition, the University, like other participants, had been required to pay a special assessment, amounting to $300,000 in the case of the University of Toronto; therefore the total premium cost for 2004-05 was $1.8-million.

Mr. Fleming noted that the insurance industry in general had enjoyed a year of spectacularly good results in 2004, with property and casualty insurers in Canada earning a net profit of $4.2-billion, up from $2.5-billion in 2003, according to the Insurance Bureau of Canada. As a result, the escalation in premiums should now be at an end.

With respect to CURIE, Mr. Fleming reported that its surplus position had declined to less than that required by the British Columbia regulators, who had placed the company on notice. That action, as well as CURIE's wish to place itself on a more stable financial footing, had led to the special assessment of $4-million on participants, of which this University of Toronto's share had been $300,000, and had also led to the successive premium increases. The

7. Risk Management and Insurance: Annual Report, 2004 (Cont'd)

outcome had been to restore CURIE to modest financial health. The University had commenced a review of its insurance strategy to determine whether it should continue to participate in CURIE beyond the current commitment, which extended to 2007. The CURIE Board was also completing a strategic review of its operations and services.

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

(a) CURIE. In response to questions, Ms Brown and Mr. Fleming said that CURIE provided the University's main property policy and its comprehensive general liability coverage. Other insurance was purchased elsewhere. CURIE's financial problems had arisen from its claims rather than from its investments (which were conservative fixed-income investments, managed by the University of Toronto Asset Management Corporation). Ms Brown and Mr. Fleming speculated that the hurricanes on the east coast might well have been the source of the largest claims, but CURIE's operating costs might also be a partial cause. One of the University of Toronto's concerns was that information of this nature had not been made available to members of the Reciprocal. In response to a question, Ms Brown said that CURIE did issue audited financial statements, which were public. That in itself did not, however, provide adequate information. This University was not represented on the CURIE Board and had concerns about the Board's structure. The Board included representatives from Canada's four regions. The review commissioned by the CURIE Board had been completed and was now before that Board for review.

Following the discussion of the University's premiums and claims with respect to the main CURIE property policy (below), there was further discussion of CURIE. In response to questions, Ms Brown said that that the University was committed to remain a member of CURIE until 2007. There were significant advantages to CURIE. Its coverage was specifically designed for universities, which would be hard to replicate in the commercial marketplace. There would be considerable uncertainty about the cost of the commercial marketplace, particularly at difficult times in the insurance cycle, and the cost of more self-insurance would be very uncertain. While the University had been a large net contributor to the Reciprocal in the past, insurance was a long-term sharing of risk. The University was at an early stage of its review, and the most desirable outcome would certainly be solutions to CURIE's problems that would enable the University to remain a member. Among other things, the withdrawal of the largest member could cause problems for the remaining member universities. It was therefore important that the University make its views known vigorously, including its concerns about the lack of information, and it had been doing so. It had also been discussing its concerns with other members in an effort to promote desirable change. In response to a question, Ms Brown said that a part of the reason for the inadequacy of information to members might well be that the small organization simply lacked the staff resources to provide good disclosure. Ms Brown stressed that CURIE had fared well financially until the past three years, covering its claims costs and also paying dividends to members. The concerns had arisen only in more recent years.

7. Risk Management and Insurance: Annual Report, 2004 (Cont'd)

b) Insurance cost: main property policy. A member noted that the University had over the past five years paid $3.59-million in premiums for its property insurance and had made no claims. Might it be possible to amend the terms of that policy to increase the $250,000 deductible and reduce the premiums, in effect self-insuring against a greater proportion of the property risk? Mr. Fleming replied that the University had asked that question and had been advised that the option was not available. Any such change would have to apply to all members of CURIE. The member observed that it was surprising that CURIE would not wish to accommodate the request. Ms Riggall assured the member that the request had been made forcefully.

In response to a question, Mr. Fleming said that there had been limited need in the past five years to draw on the University's self-insurance reserve for significant claims under the $250,000 deductible. There had been a claim arising from water damage about four years ago.

A member asked whether it might be possible to reduce premium costs by excluding certain assets from the property policy and self-insuring them. Mr. Fleming replied that doing so would be very difficult. While the University might consider self-insuring its newer buildings, for example, the insurer would likely be unwilling to insure only the more vulnerable older buildings. In addition, there might well be need to make claims arising in the newer buildings. For example, the water-damage claim on the self-insurance reserve (noted above) had arisen from a new building, the Academic Resource Centre (ARC) at Scarborough, where a sprinkler pipe had ruptured a few months after the building had been commissioned for occupancy.

A member asked how rates were determined. Ms Brown replied that CURIE used a formula recommended by its actuaries. The maximum discount for good claims experience was 25%.

(c) Vehicle insurance. In response to a question, Mr. Fleming said that the University self-insured for the costs of repair or replacement of its vehicles as the result of any collisions. The insurance on its vehicle fleet covered only third-party liability.

8. Capital Projects: Financial Report

Ms Brown said that the capital-projects report was a variance report, showing the approved cost for each capital project and the projected cost to completion. The column showing the approved "costs as per capital plan" contained the costs included in the capital-project reports presented to each meeting of the Business Board. The projected cost was the actual cost of completed projects or the estimated cost to completion as of the report date. The report did not show any substantial variances. If the administration proposed a change to the scope of the project, or if it foresaw a change to its cost for some other reason, it would move at an early stage to seek approval of the new cost. The approval of the Governing Council, on the recommendation of the Planning and Budget Committee and the Academic Board, was required for the initial approval of each project costing more than $2-million. That approval included the

8. Capital Projects: Financial Report (Cont'd)

site, space plan, total project cost and sources of funding. Similar approval was required for any substantial change to any of those elements of a project. The approval of the Business Board was required before any project could be undertaken. That Board ensured that the project was properly financed and ready to proceed to construction. If the project remained unchanged in its scope, but if the cost would exceed the approved cost by the lesser of 10% or $2-million, the administration was required to seek the approval of the Business Board for the cost increase.

Two members suggested that the report show the original cost for each project, before any approval for increased scope or cost, and compare that cost to the projected cost to completion. A number of points arose in a lengthy discussion.

- **Need for vigilance to ensure that costs of major projects did not escalate out of control**. It was very important with respect to the very large projects, such as the Donnelly Centre for Cellular and Biomolecular Research or the Leslie Dan Pharmacy Building, to learn at an early stage of any risk of costs escalating seriously – of the projects "going off the rails." The concern was not so much approved changes in the scope of projects as cost escalation within approved project parameters. Ms Riggall stressed that the administration simply could not proceed to spend more than 10% above the approved cost, to a maximum of $2-million. Any such increase would require the approval of the Business Board. She had used her authority to approve increased spending on capital projects below the 10% / $2-million limit only on two occasions during her tenure as Interim Vice-President and as Vice-President.

- **Jurisdiction**. The Business Board currently received a report on all projects in the capital plan at each of its meetings. It also received project completion reports, which provided full information on the evolution and completion of each project. That Board was charged by the Governing Council with responsibility for oversight of the execution of capital projects. The report currently before the Committee was submitted on the Committee's request and not because the Business Board had delegated a role to the Audit Committee.

  A member observed that, while it was true that the Business Board received capital project reports at each meeting and while it received completion reports on all projects, it appeared from the project completion report on the Bahen Centre for Information Technology that additional work was required even after the project completion report. Ms Brown replied that the objective was to bring projects to a formal completion and to present project completion reports in a timely manner, with any remaining remedial work required after the projection completion report regarded as part of the on-going cost of the building.

  Another member suggested that if the Audit Committee had no role, it should receive no report on capital projects rather than an incomplete report and one that would not enable it to add any value.

8. Capital Projects: Financial Report (Cont'd)

A member said that the Committee did have a responsibility with respect to controlling risk, and the risk associated with the execution of major projects would be very considerable for a company in the construction business and all the more so for the University, which was not in that business.

A member, who also served on the Business Board, said that that Board was kept very much up-to-date on the capital program. While he agreed that it would be difficult for the Audit Committee not to be concerned about a $1-billion capital program, there was already a high level of governance oversight in place.

The Chair said that the Committee was responsible for the integrity of financial controls, and any control failure on very large projects would be very costly to the University and very visible. He was not concerned about the properly approved decisions to expand the scope of projects, but he was very concerned about the risk of cost overruns.

A member observed that the Committee met infrequently and, in the event of any problem, it would probably receive information too late for it to act effectively. If the Committee did become involved in monitoring the cost of capital projects, it would have to review a report at each and every meeting. It was unlikely that the Committee would discover any problem that had not already come to light in the Planning and Budget Committee or the Business Board, but it could act if it discerned a trend that required changes to controls.

- **Controls on capital projects**. A member recalled that the Committee had received a report on controls on capital projects, and he suggested that the Committee could best add value by periodic review of those controls. Another member agreed that reviewing controls was the most useful role the Committee could play. In response to a question, Mr. Britt said that the Internal Audit Department had completed a review of controls on capital projects about two years ago.

- **Review of the process for capital projects**. A member suggested that the Committee's review of a full report on capital projects, comparing original costs with projected costs, could provide valuable information about the capital-project process at the University. If such a report were to show that projects were frequently enlarged beyond their original scope, for example, that would be valuable information for the Business Board to have in considering proposals for new projects.

Ms Brown said that she would take under advisement the Committee's discussion and consider adding further information to the regular report. She would also arrange for the Committee to be briefed again on the control system with respect to the planning and execution of capital projects.

9. Report of the Administration

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

10. Date of Next Meeting

The Chair reminded members that the next regular meeting was scheduled for Wednesday, June 22, 2005 at 12:00 noon. The major item of business at that meeting would be the review the audited financial statements.

11. Other Business

(a) External Auditors

Ms Tory reported that Mr. Keith Bowman, Ernst & Young's previous engagement partner on the external audit, had decided to retire from the firm one year early to enable his daughter to join a client of Ernst & Young without risk of a conflict. Ms Tory had served as the engagement partner previously. While she had not been actively engaged, she had retained familiarity with the University and the audit as the reference partner, and her practice had concentrated on universities. The Chair welcomed Ms Tory back.

(b) University of Toronto Innovations Foundation

A member recalled that at the time of the presentation of the annual report and audited financial statements of the University of Toronto Innovations Foundation, the Committee had been advised that a review of the Foundation had been undertaken by the Honourable John Manley, that the review had been completed, and that a report had been delivered. The administration had said that it would take some time to digest the report and consider its response, after which the report would be shared with the Committee. Ms Brown replied that the administration's consideration of the matter was still underway. In response to the member's question, Ms Brown said that the report had not yet been forwarded to any Governing Council committee.

(c) Ontario Budget

In response to a member's question, Ms Brown commented on the implications to the University of the recent Ontario budget.

The meeting adjourned at 6:50 p.m.

Secretary	Chair

June 8, 2005