

UNIVERSITY OF TORONTO  
THE GOVERNING COUNCIL

Item 8 ( See Report Item 2  
and Appendix "A")  
Item 9(c)

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE**

**May 22, 2002**

To the Business Board,  
University of Toronto.

Your Committee reports that it met on Wednesday, May 22, 2002 at 5:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. Robert S. Weiss (In the Chair)  
Ms Christine A. Capewell  
Ms Paulette L. Kennedy  
Ms Kwai Li  
Mr. Paul E. Lindblad  
Mr. George Myhal  
Mr. Richard Nunn  
Professor Wally Smieliauskas

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

Secretariat:

Mr. Neil Dobbs\*\*  
Ms Susan Girard\*\*

Regrets:

Mr. Donald A. Burwash  
Mr. Felix P. Chee

Mr. Gerald A. Lokash  
Mr. Roger P. Parkinson

In Attendance:

Mr. Keith B. Bowman, Ernst & Young\*\*  
Mr. Raymond L. Chow, Ernst & Young\*\*  
Mr. Donald W. Lindsey, President and Chief Executive Officer, University of Toronto  
Asset Management Corporation\*  
Mr. Pierre Piché, Associate Controller\*\*  
Ms Julianna Varpalotai-Xavier, Chief Operating Officer, University of Toronto Asset  
Management Corporation\*

\* In attendance for item 2.

\*\* Absented themselves for the consideration of item 11.

ITEM 2 CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD FOR APPROVAL

**1. Report of the Previous Meeting**

Report Number 63 (November 28, 2001) was approved.

**2. University of Toronto Asset Management Corporation**

**(a) Financial Statements, 2001**

The Chair observed that the University of Toronto Asset Management Corporation (UTAM) was classified as an "incorporated business ancillary operation" like the University of Toronto Press and the Innovations Foundation. Unlike the other ancillary operations, the

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****2. University of Toronto Asset Management Corporation (Cont'd)****(a) Financial Statements, 2001 (Cont'd)**

Business Board had received directly and dealt with the UTAM's annual report, considering such matters as investment strategies and returns. Before the establishment of a separate investment-management corporation, the Business Board had regularly received an annual report on investments and, given the stakes involved, it wished to continue to receive that report directly. The Audit Committee's role therefore was a limited one, but an important one: to review and be satisfied with the financial statements and with the controls over the invested assets.

Mr. Lindsey said that UTAM's financial statements were simple. The corporation was not intended to make money as a result of its operations; rather the cost of those operations represented, in effect, a budget item for the University. UTAM's agreement with the University required that the UTAM budget be approved by the Vice-President, Business Affairs. It was also approved by UTAM's own Board, and the Board's Audit and Compliance Committee reviewed quarterly update reports comparing expenditures to the budget. UTAM's expenditures fell into two categories: (a) the costs of its own operations, and (b) the amounts paid to external investment-portfolio managers and other service providers such as the custodians of the assets. Mr. Lindsey observed that the UTAM annual report was a very detailed one, but he thought it appropriate to communicate as much information to constituents as possible.

Among the matters that arose in discussion were the following.

**(i) Accounting for incentive compensation.** Ms Varpalotai-Xavier said that she had been asked by the Chair to comment on one new item on UTAM's financial statements, relating to staff compensation. She noted that 2001 was UTAM's first full year of operation. The balance sheet showed an asset, deferred compensation plan, amounting to \$7,307, offset by an identical liability. Note 4 described the deferred compensation plan. UTAM's senior managers were eligible for incentive compensation if (and only if) investment performance achieved certain levels relative to their benchmarks. One half of the incentive compensation award was paid in cash and one half was deferred to be vested in equal amounts over the following three years provided that the senior manager remained a UTAM employee. The deferred amount was invested in units of the Long-Term Capital Appreciation Pool (L.T.CAP), giving the managers a direct interest in the returns of the L.T.CAP. The award of incentive compensation was made by the UTAM Board after the year end, depending on performance during the year. The amount of \$7,307 represented the liability for the amount that had been awarded and vested as at December 31, 2001. The other amount cited in the notes, \$71,212, represented the amount that had been awarded as at December 31, 2001 and invested in the L.T.CAP but not yet vested. It was not treated as a liability on the balance sheet because there was no certainty that all of the managers would remain with UTAM for the full three years and therefore that the full amount would be vested. Because the awards were made after year end, the amount appearing on the statements for the year ended December 31, 2001 represented the incentive compensation awarded in 2001 for UTAM's first and partial year of operation, which was 2000.

Two members questioned whether this accounting treatment was appropriate. The matching principle would, in their view, require that the amount of compensation earned because of work in 2001 be recorded as an expense in the 2001 financial statements. Asked to comment, Mr. Bowman said that the matter had been considered by specialists in his firm who had advised that it would be appropriate to charge the cost of incentive compensation only when it became vested. If individual managers remained with UTAM, their incentive compensation would be

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****2. University of Toronto Asset Management Corporation (Cont'd)****(a) Financial Statements, 2001 (Cont'd)**

vested; if they did not, the amounts would not be vested and would not therefore become a UTAM expense. A member suggested that the wording of the balance sheet be amended to make it clear that the amounts with respect to the deferred compensation plan referred only to the current year and that the note be revised to make it clear that some of the incentive compensation earned as a result of performance in 2001 would be deferred and vested only in 2002 and later years.

The Chair noted that the current accounting did mean that there was a potential liability that was not disclosed in the financial statements. He asked if there was a cap on that liability. Mr. Lindsey replied that incentive pay for the managing directors depended 80% on investment performance, with about 20% dependent on a judgement of the achievement of certain other goals established before the beginning of the year. While UTAM was a new organization, the performance used to determine incentive compensation would ultimately be based on four years of returns. If four-year investment returns were exceptionally good in relation to the benchmarks, incentive compensation could be as much as 75% of salary. If investment performance was poor relative to benchmarks, there would be no incentive compensation.

In response to a member's question, Mr. Lindsey said that investment performance was measured externally by the custodian, State Street Canada. Ms Brown noted that all senior compensation awards were reviewed carefully by the Compensation Committee of the UTAM Board, consisting four Board members including the President of the University, the Vice-President, Business Affairs, the Chair of the UTAM Board, and another UTAM director, who was Chair of the Compensation Committee. The current Chair was Mr. H. G. Emerson, who was also a member of the University's Business Board.

**(ii) Management expense.** Mr. Lindsey responded to a member's question about the management expense ratio (M.E.R.) for the major funds managed by UTAM and a comparison of that ratio to those for other university funds. The cost for UTAM's own operations was 7½ basis points (0.075% of assets managed). The budgeted cost had been 7 basis points, but the higher M.E.R. had resulted from the decline in the value of the assets owing to the very bad securities markets during the year. The cost for both UTAM's operations and the amounts paid by UTAM to external portfolio managers and other service-providers (such as custodians of the assets) amounted to 42 basis points (0.042%) for the Long-Term Capital Appreciation Pool (the pool that contained most of the University's endowments as well as some other funds) and 35 basis points for the pension fund. The M.E.R. for the L.T.CAP was higher because it was a more diversified fund, with more investment mandates, for example more investments outside of Canada. The cost of 7.5 basis points for UTAM's operations was very low compared to that of other investment management companies with a comparable investment program and comparable assets, where the typical cost was between 8 and 11 basis points, with some as high as 10 - 15 basis points. UTAM planned to add only one or two more staff analysts and some additional software. Those additional expenditures would enable UTAM to manage a substantial growth in assets. With this limited growth in expenditure and the anticipated growth in the value of the assets under management, Mr. Lindsey anticipated that the M.E.R. for the funds would decline over time.

In response to a question, Mr. Lindsey said that UTAM received no services from the University that did not appear in its budget and financial statements. It was responsible for its own space

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002**

**2. University of Toronto Asset Management Corporation (Cont'd)**

**(a) Financial Statements, 2001 (Cont'd)**

costs, and it reimbursed the University for services such as insurance. Because those costs were ultimately paid by a reduction in investment income, it was, of course, important that the University know how much income was being given up.

Mr. Lindsey observed that two approaches were possible. First, UTAM could be paid an agreed rate, based upon market rates, and UTAM itself would then be responsible for ensuring that its expenses were less than its revenue. That alternative had not been chosen, although the University might still consider it. The other alternative was the cost-recovery arrangement, with the University approving the UTAM budget.

A member suggested that the notes make it clear that the source of UTAM's revenue was recovery from the funds managed. Ms Brown and Ms Varpalotai-Xavier observed that in the case of the L.T.CAP and the Expendable Funds Investment Pool, the payment passed through the University's accounts. In the case of the pension master trust, the payment was shown as an expense on the financial statements of the two pension funds. The recovery of investment costs from the funds was not new with UTAM; those costs had been similarly recovered when the University oversaw its investments through its own Treasury Department. It was AGREED (a) that the notes to UTAM's financial statements for 2002 should make it clear that the source of UTAM's revenue was recovery from the funds under management; and (b) that the information would be adequately disclosed for 2001 through its appearance in this report to the Business Board.

On the recommendation of the Vice-President, Business Affairs

**YOUR COMMITTEE RECOMMENDS**

THAT the audited financial statements of the University of Toronto Asset Management Corporation, December 31, 2001, a copy of which is attached hereto as Appendix "A", be accepted.

**(b) Report on Controls with respect to University and Pension Plan Assets**

Mr. Lindsey reported that UTAM staff had spent a great deal of time working, in cooperation with external consultants and Mr. Britt, on controls. Mr. Varpalotai-Xavier recalled that UTAM had, one year ago, provided the Committee with an extensive report on UTAM's control environment, and she was pleased to update the report at this time.

- **Documentation of internal policies and procedures.** UTAM was making progress on documenting its policies and procedures. While completion of that task had been delayed because of other priorities, it would be completed. The investment-management due-diligence process was, meanwhile, being carried out.
- **Due-diligence visits to portfolio managers** had been prioritized on the basis of the risk associated with each manager. Hedge-fund managers had therefore been assigned the highest priority, with UTAM staff interviewing both investment and administrative personnel. Three quarters of the hedge-fund managers had been visited, and all visits would be completed by the end of the second quarter of 2002. All portfolio managers

## REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002

## 2. University of Toronto Asset Management Corporation (Cont'd)

## (b) Report on Controls with respect to University and Pension Plan Assets (Cont'd)

would have been visited by the end of the first quarter of 2003, with subsequent visits following in a rotation, except that any issue that might arise would result in immediate action. Mr. Lindsey stressed that the visits by UTAM's Manager of Compliance and Reporting were intended solely to examine the portfolio managers' back-office and compliance functions. UTAM's managing directors also visited portfolio managers, and met with them at the UTAM offices and by telephone, to carry out examinations of the managers' investment processes.

- **Custodian's compliance reporting.** The funds' custodians, State Street Canada, were now providing extensive compliance reports, which had been designed in cooperation with UTAM. Compliance reporting was provided on a daily basis except for some aspects where compliance could be assessed only after the month-end. UTAM was working with State Street to allow appropriate UTAM staff to have on-going access to compliance reporting available on their desk-top computers.
- **Risk-assessment framework.** UTAM had engaged Deloitte + Touche as consultants to prepare a risk-assessment framework. Deloitte + Touche had consulted with Mr. Britt when developing the risk-assessment framework, which the consultants had presented to the UTAM Audit and Compliance Committee at a meeting early in May.
- **Initiation of limited in-house trading.** UTAM had in the fall of 2001 commenced a limited program of trading fixed-income securities and futures in house. UTAM was in the process of increasing the size of that in-house program. Control procedures had been presented to the UTAM Audit and Compliance Committee at a meeting in August, 2001.

Mr. Britt stated that he had frequent discussions about UTAM's controls with Mr. Lindsey, Ms Varpalotai-Xavier and Ms Tiffany Palmer, UTAM's Manager of Compliance and Reporting, and he had attended all meetings of UTAM's Audit and Compliance Committee. That Committee consisted of highly qualified individuals and was well informed and committed to good governance at UTAM. UTAM's management had been highly responsive and diligent in addressing matters raised by the Committee. That Committee had carefully reviewed the risk-management framework proposed by the consultants, Deloitte + Touche, and supported the consultants' proposal. There had been some question concerning the role of the University's Internal Audit Department in the operation of that framework, arising primarily from limits to the Department's resources. The outcome had been a decision that the University's Internal Audit Department, with financial support from UTAM, would conduct reviews pursuant to the Deloitte + Touche framework to ensure that the risks were being satisfactorily controlled. Mr. Britt was therefore preparing an internal audit plan and program for UTAM, which would be presented to the UTAM Audit and Compliance Committee in August. Mr. Britt added that the Deloitte + Touche exercise had observed no significant areas of unmitigated risk. There was need to document some policies and procedures, but, as Ms Varpalotai-Xavier had reported, that task was being completed over time. Mr. Britt would report back to the University's Audit Committee, as well as the UTAM Audit and Compliance Committee, on a regular basis on the results of reviews and any significant findings.

In response to a member's question, Mr. Britt said that the Internal Audit Department would be able to undertake the new work concerning investments, notwithstanding current

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****2. University of Toronto Asset Management Corporation (Cont'd)****(b) Report on Controls with respect to University and Pension Plan Assets (Cont'd)**

staffing limitations, because the Department would be hiring an additional auditor with expertise in this area. UTAM would compensate the Internal Audit Department for a proportion of the salary and benefits costs of this individual based on the number of hours committed to UTAM work in the forthcoming UTAM internal audit plan. In response to a second question, Mr. Lindsey said that the UTAM Audit and Compliance Committee was scheduled to meet four times a year but, because of the UTAM's needs at this early stage of its development, additional meetings had been held.

The Chair concluded that basically all controls at UTAM were in place, but the situation was a dynamic one with need for continuing changes and improvements. Mr. Lindsey agreed. Putting policies and procedures into place and documenting them represented a great deal of work, and UTAM staff would work with Mr. Britt to ensure that all policies and procedures were in place, documented and kept up to date with best practice.

**3. Business Arising from the Report of the Previous Meeting****(a) Item 6 - Risk Assessment Profile**

**(i) Governance responsibility for monitoring the risk-assessment process.** The Chair recalled that the Secretary of the Governing Council had been asked to take the steps necessary to ensure that some committee of the Governing Council was assigned responsibility for monitoring an annual risk assessment. The matter had been dealt with in the proposed, revised terms of reference for the Audit Committee, which, if approved, would make the Committee responsible for that task.

**(ii) Audit Committee responsibility with respect to financial-reporting risk.** The Chair recalled the suggestion that the relevant section of the risk-assessment profile be revised to make it clear that the Audit Committee's responsibility was limited to: (a) ensuring only the material correctness of only the financial reports that came before the Committee, as well as (b) ensuring that appropriate financial-reporting policies and procedures were in place and were tested periodically. Ms Brown stated that the next risk assessment profile would define the Audit Committee's responsibility more precisely.

**(iii) Action with respect to business-interruption risk (computer technology) and other areas of insufficiently mitigated risk.** The Chair reminded members that the Committee had been advised that the Director of Administrative Management Systems was preparing a plan and a cost estimate for a recovery plan in the event of a computer disaster. The Committee had also requested a follow-up report on the administration's decisions with respect to other areas of risk which were not seen to be satisfactorily mitigated. Those areas included fire risk in the Robarts Library and risk associated with a widespread power failure comparable to that caused by the recent ice storm in Quebec and eastern Ontario. Ms Brown reported that the matters had been given further consideration, but the current long-range budget plan provided no source of the substantial amounts of funding that would be required to deal with those problems. A new budget plan would be finalized under the direction of the new Vice-President and Provost, Professor Shirley Neuman, and Mr. Chee would work with Professor Neuman to determine whether funding could be allocated in the new plan to achieve a more satisfactory mitigation of those risks. With respect to computer disaster recovery, further work was being completed. The Director of the Administrative Management Systems was seeking to take advantage of the fact

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****3. Business Arising from the Report of the Previous Meeting (Cont'd)****(a) Item 6 - Risk Assessment Profile (Cont'd)**

that the University operated on three campuses in order to develop a cost-effective solution. While a creative solution could reduce the costs of a computer disaster-recovery plan, there would still be a very substantial cost, and again that cost would be considered in the development of the new long-range budget plan.

A member said that implementation of a plan to deal with computer disaster had become an accepted business practice. While the Committee could not second-guess budget-allocation decisions, it was important for it (a) to understand who would be held accountable in the event of a computer disaster, and (b) to know what the Committee's role should be. The Chair replied that in the absence of knowledge of and influence over the budget process, the Committee's role was necessarily limited. It could not and should not seek to assign priority to one area over another, for example, risk mitigation rather than additional student financial support. It was, however, responsible for ensuring that risks were being assessed and addressed. If the outcome was not deemed to be satisfactory, the Committee then could and should state its view forcefully, as it had when it was monitoring the University's readiness for the transition to the year 2000. It was AGREED that the Committee support Mr. Chee's intention to raise with the new Provost in the long-range budget planning process consideration of funding for the items of unsatisfactorily mitigated risk identified in the 2001 risk-assessment profile, including business-interruption risk - computer technology; and that the Committee request a follow-up report in the fall of 2002 with respect to the outcome.

**(iv) Contracts risk.** Mr. Charpentier reported that he had begun the process to further mitigate contract risk. He had prepared and presented to the committee of the President and Vice-Presidents a new draft policy on the approval and execution of contracts and documents. That group had provided advice and had instructed that there be consultation with particular individuals within their portfolios. Those consultations would be completed and a revised policy would be presented to the President and Vice-Presidents and subsequently to the group of Principals, Deans, Academic Directors and Chairs. Broad consultation was important not only to ensure that the revised policy was as good as possible but also to ensure that it was implemented satisfactorily. It was anticipated that consultations would be complete by late in the fall. Moving signing authority further down the administrative hierarchy would be appropriate but would have to be accompanied by an educational and developmental process. The work completed to date had been valuable in itself because it had made the University's leadership more aware of the concerns. The Chair requested a follow-up report in the fall.

**(b) Item 7, Report of the Administration: Publicity to Wrong-Doing**

The Chair recalled that the Committee had requested a comment on the University's policy with respect to giving publicity to cases where wrong-doing had been discovered. That publicity would include use of the wrong-doer's name, in order to deter others. Mr. Charpentier and Ms Brown reported that the University would continue to give publicity to wrong-doing, using names, wherever possible. Mr. Charpentier did, however, caution, that such action was not always possible and that judgements would have to be made at the senior level in each case. In some cases, the University had received legal advice not to disclose the names of wrong-doers at various stages of proceedings or not to disclose them at all. It was also necessary to be mindful of potential damage to the reputation of the University or its divisions in certain cases. He noted that in the case of academic offences by students, the University routinely gave publicity to convictions and penalties, but it usually did not disclose students' names.

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****3. Business Arising from the Report of the Previous Meeting (Cont'd)****(c) Item 8, External Audit Plan and External Audit Fees**

The Chair recalled that because of on-going discussions about external audit fees, the Committee had not at its November meeting received the usual report on the external audit plan and external audit fees. He recalled that Mr. Chee had distributed the external audit plan to members early in December, 2001, and the report on external audit fees appeared on today's agenda.

**4. Financial Statements, 2001-02: Draft Notes**

The Chair noted that the Committee traditionally considered the draft notes to the financial statements at a meeting held late in May or early in June, before the presentation of the statements themselves. Because of the short time between the April 30 end of the fiscal year and the final meeting of the Governing Council in June, this earlier review of the notes assisted in dealing with the tight timeline for preparation and governance review of the statements.

Ms Brown reported that the main change in the notes for 2002 arose from the University's issue of a senior unsecured debenture in July 2001 in the amount of \$160-million, to be used to finance capital projects. Note 8 described the new debenture issue, and notes 5 (capital assets) and 6 (investment in capital assets) presented separately the assets financed by the debenture issue to facilitate the flow of information from the balance sheet to the notes. Other changes were largely of a housekeeping nature. Note 2(d) from the previous year's statements, which described the change in method of accounting for employee benefit plans, was removed. Note 13 on the Ontario Student Opportunity Trust Fund was enhanced at the request of the Ontario Ministry of Training, Colleges and Universities to display the number of bursaries awarded from the endowment funds established under this program. All changes were underscored, scored out, or black-lined in the margin. The administration would continue to work on the notes until the draft statements were issued in June; any further changes would be reported to the Committee at its June meeting. Among the further changes planned was note 4, investments. The section on pooled funds would be amended to remove the listing of individual pooled funds and to disclose instead the amounts invested in various categories of pooled funds: bond funds, Canadian equity pooled funds, etc. A member commended the planned change.

The Chair observed that the Committee was responsible to ensure the adequacy of public disclosure of financial information. This function had become even more important in the light of accounting deficiencies by a number of major private-sector companies in the U.S. Ms Brown stressed that the notes represented only one part of the year-end package. That package also contained the financial statements, including the notes, the financial highlights and the supplementary financial report. All three elements would be presented at the June meeting.

Among the matters that arose in discussion were the following.

**(a) Note 3, Employee benefit plans – deferred pension charge.** Asked to explain the deferred pension charge, Mr. Piché said that the accounting rules for pensions required the actuaries to calculate the cost of providing pension benefits. The actuarial calculation took into account not only the cost of providing pensions but also the investment returns on the pension fund. In years of good investment returns, the cost of providing pensions would be reduced to the point of creating a negative pension expense, described as pension income, which would be set aside for future years when the University would be required to record pension expense. In years when the University was required to incur a pension expense, the expense would reduce that reserve. So



## REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002

**4. Financial Statements, 2001-02: Draft Notes (Cont'd)**

long as there was a reserve, the pension expense would be an accounting expense only. This reserve appeared on the balance sheet as an asset, the deferred pension charge, and in funds committed.

**(b) Note 4(a), Investments: derivative financial instruments.** A member observed that it was always a challenge to provide the best possible information concerning derivative financial instruments. It was typical to disclose their fair market value and to describe how that value was derived. The note disclosed counterparty risk with respect to exchange-traded futures contracts and indicated that the risk was minimal because the counterparties were clearing corporations with AAA credit ratings. The member thought it likely that the counterparties for the other derivative instruments – foreign-exchange futures contracts – were likely to have a credit rating less than AAA. All of the financial instruments had no doubt been disclosed, but it might be easier to understand the information if it was presented in tabular form. Another member suggested that the notes include information about the agency that regulated the counterparties in the derivative contracts.

Mr. Lindsey and Ms Varpalotai-Xavier noted that there had been a recent change in Generally Accepted Accounting Principles (GAAP) with respect to reporting derivative instruments that required, among other things, the disclosure of their fair value. Ms Varpalotai-Xavier was working with Mr. Piché on a revised note that would use a tabular format, would disclose the fair value of the derivative contracts, and would also disclose their embedded risk.

**(c) Note 5, 6 and 8, Debenture.** In response to a question, Ms Brown said that the \$160-million debenture was unsecured in that there was no covenant pledging assets as security for the money borrowed through the issue. The University had stated that it planned to use the proceeds primarily for capital projects but that it might also use some of the proceeds for other purposes. While the University did indeed plan to use the money to finance capital projects, there was no restriction on the use of the proceeds for that purpose only. The \$160-million would be allocated to finance various projects over time; an amount of \$57.2-million had been allocated by the April 30, 2002 end of the fiscal year.

**(d) Note 18(b), Contingencies: litigation.** A member observed the statement in note 18(b) concerning litigation, “In the unlikely event any claims are successful . . .” Mr. Bowman said that the wording had been used for some years. The University was the object of frequent legal actions. The administration and the auditors reviewed an assessment from the University’s law firms concerning the likelihood of success in those actions and the amounts that might be awarded if the actions were successful. Mr. Bowman said that those letters had not yet been received, and it might be necessary to change the wording of the note when the letters were reviewed.

A member recalled that the Committee received an annual report in the fall on the University’s use of legal services, which report was intended to help the Committee assess the risk of contingent liability from legal action. After discussion, it was AGREED that the Committee request that the report be presented in the spring, at the same time as the financial statements and that it include a summary report on outstanding litigation to assist the Committee in evaluating the section in the notes dealing with contingencies.

A member recalled that another question had arisen during the discussion of the most recent report on legal expenditures: whether some of the expenditures could be recovered. Ms Brown replied that legal fees for the administration of estates or bequests might well be recovered from

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****4. Financial Statements, 2001-02: Draft Notes (Cont'd)**

the proceeds, but the small amounts involved would not be of interest to the Audit Committee. The primary objective of the report on the use of legal services was to provide a rough indication of the level of contingent liability so that the Committee could satisfy itself with respect to the disclosure in the notes.

**(e) Contingencies: future revenues.** A member observed that there was some uncertainty about government operating funding for enrolment expansion, but that uncertainty had not been disclosed in the notes. Ms Brown thought that commentary on future-oriented matters would be best in the financial-highlights section of the financial report rather than in the financial statements themselves. This uncertainty had been noted as an area of high risk in the risk-assessment profile.

In the course of discussion, the Chair pointed out that the dollar figures in the financial statements were currently presented in terms of thousands of dollars. The administration had requested the Committee's view about whether it would be appropriate to begin stating the numbers in millions, rather than thousands, of dollars. Ms Brown said that the numbers were becoming larger over time, and it might well be easier to read the statements if they were expressed in terms of millions of dollars. If the Committee thought that the change would be a worthwhile one, it could be implemented for the 2001-02 statements. It was AGREED that it would be appropriate to begin expressing dollar figures in the financial statements in terms of millions of dollars.

The Chair said that the notes to the financial statements had been developed over many years, and a fresh look at them was often useful. Therefore, having a separate discussion of the notes at the meeting preceding the consideration of the financial statements had been very helpful. But, with the wave of changes to the notes likely over, the Committee might like to consider whether the separate prior discussion was still helpful. Ms Brown said that it was valuable to the administration to have a discussion of the wording in advance, but members might question the value of examining the notes in the absence of the numbers for the year. A member said that she thought the practice was a valuable one. Matters had come up regularly, and dealing with them in advance could prevent an unmanageable meeting in June.

**5. External Auditors' Engagement Letter, 2001-02**

Mr. Bowman said that the engagement letter itself contained no significant changes from the previous year. The statement of "standard terms and conditions," attached to the engagement letter, had not been included with the 2001 engagement letter. Those terms and conditions were, however, only standard ones. They did not contain a clause limiting the auditors' liability. He had discussed with Mr. Chee and Ms Brown the inclusion of such a clause, but Ernst & Young had agreed to remove it for this year and to consider the matter further in the future.

Ms Brown stated that she was comfortable with the "standard terms and conditions." They incorporated only standard practices.

**6. External Audit Fees**

Ms Brown said that the report contained the external auditors' proposed fees for 2002, the supplementary schedule of fees for tax advice and other matters for 2000-01 (intended to enable the Committee to deal with the question of the auditors' independence) and the survey of audit fees paid by other Ontario universities from 1998-99 to 2000-01 – a survey carried out by the

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****6. External Audit Fees (Cont'd)**

Council of Finance Officers – Universities of Ontario (COFO-U.O.) The University had agreed to a \$3,000 increase in the fee for the main operating-fund audit, bringing the total fee to \$100,000. Because the fee had remained unchanged for several years and because the fees for many of the smaller audits had remained unchanged, the increase appeared to be reasonable. Ms Brown noted that the total fees for auditing services for 2001 had been substantially higher than the original estimate for two reasons. First, Ernst & Young had audited the offering memorandum for the University's debenture offering. Second, the firm had been required to audit a large number of capital projects sponsored by the Ontario Research and Development Challenge Fund.

Among the matters that arose in discussion were the following.

**(a) Fee for the audit of the University of Toronto Press Inc.** A member expressed surprise that the fee for the audit of the Press's financial statements would be 60% of that for the University's. The Chair and Mr. Britt cited two factors. First, the cost of the University's audit was reduced substantially owing to the work carried out by the Internal Audit Department. Second, the Press was a complex organization, operating a number of businesses and having its own board and audit committee.

**(b) Supplementary schedule: assistance with recovery of Goods and Services Tax (G.S.T.)** A member asked whether the fees for advice concerning the recovery of G.S.T. payments were contingency fees. A number of companies had found that, over time, the fees were high relative to the ultimate savings, which were sometimes subsequently reduced owing to audits by the Canada Customs and Revenue Agency (C.C.R.A.). Ms Brown replied that the University had experienced no problem. Its efforts to recover G.S.T. payments had focused on particular areas; the University had not sought to be a leader in exploiting loopholes. Ms Brown was comfortable that the University had received good value for money for G.S.T. consulting services. Mr. Bowman noted that the C.C.R.A. now reviewed refund applications carefully before granting them.

**(c) Possible incremental costs.** The Chair observed that two of the footnotes to the fee proposal indicated the possibility of incremental costs. Mr. Bowman replied that he now anticipated that there would be no additional costs.

**(d) Fees for services by other firms.** A member recalled that the guests from the University of Toronto Asset Management Corporation (UTAM) had reported on consulting work competed by Deloitte + Touche. The Chair noted that for all of the incorporated ancillaries, consulting fees might be incurred, and would be controlled, by their boards and audit committees.

**(e) Adequacy of the audit scope.** A member asked whether the fee caused Ernst & Young to restrict the scope of the audit in any way. Mr. Bowman replied in the negative. It had been several years since the previous fee increase. At the same time, the University's operations had become more complex, and Ernst & Young's costs had increased. The fee increase had therefore been needed.

**(f) Independence letter.** In response to a member's question, Mr. Bowman said that the firm would submit its independence letter to the Committee at the June meeting.

**(g) Consulting assignments: software development.** In response to the Chair's question, Ms Brown said that the University had not engaged Ernst & Young to assist with the

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****6. External Audit Fees (Cont'd)**

development of new administrative or financial software. The University had now completed much of its work with respect to implementing its administrative management systems, and it would be unlikely to engage an accounting firm to assist with any future development.

**(h) Possibility of a policy on consulting fees by the external auditors.** The Chair noted that many corporations were adopting or considering a policy prohibiting the engagement of their external auditors for any consulting assignments or limiting the areas for such assignments. In the absence of such a policy, the external auditors could have a motivation to be less rigorous in their audit work in order to avoid causing offence to management and therefore risking lucrative consulting work. Ms Brown said that both the administration and the Committee carried out an annual review of fees paid to the external auditors for supplementary work. The total amount was small, and the individual consulting assignments were small and diverse. In the light of this annual monitoring, Ms Brown did not think there was any need for a policy. At the Chair's request, Mr. Bowman commented. Ernst & Young had sold its consulting firm, eliminating much of the potential for any problem. The firm still did carry out "due diligence" work. Some audit clients had stopped hiring the firm for any consulting work. They had concluded that it was inappropriate for the firm, for example, to value potential acquisitions and then to audit financial statements that included valuations of those same acquisitions. Other audit clients continued to engage the firm for consulting, taking the view that the firm's knowledge of the client allowed the firm to provide better consulting advice. The firm's own policy was to avoid work that might raise questions about its independence, either declining consulting assignments or resigning as auditors. Mr. Bowman noted that he anticipated that extensive regulations would be issued by the Canadian Institute of Chartered Accountants to prevent conflict situations and to ensure auditor independence.

After further discussion, it was AGREED that so long as the Committee continued to review the supplementary schedule of fees and remained comfortable that there was no risk to the auditors' independence, there was no need to develop a policy prohibiting or limiting consulting assignments.

**7. Internal Audit: Annual Report, 2001-02**

Mr. Britt presented the annual report of the Internal Audit Department. Of the 22 departmental audits included in the 2001-02 plan, the Department had completed or drafted 12 audit reports with a further 3 audits in progress, representing action on 15 of the planned 22 departmental audits. Owing to staffing problems, 7 departmental audits had not been undertaken. In addition to departmental audits, the Department had completed 3 continuous audit quarterly reports with a further audit in progress as at the end of the fiscal year. It had also completed 4 special reviews, all subjects of reports to the Committee at its November meeting. The fifth special audit was the annual audit of student societies. The Department had completed 14 follow-up audits and had assisted the external auditors with the year-end financial statement audit. The Department had also worked with staff from the Administrative Management Systems (A.M.S.) Department to configure the Audit Information System module of the A.M.S. That module would enable both A.M.S. administrators and Internal Audit staff to find, evaluate and download information from the systems and to produce reports for both systems and business-process audits.

Mr. Britt said that the Department had encountered staffing problems as the result of two extended absences for health reasons, combined with the departure of one staff member and uncertainty concerning funding for a replacement. The problems had caused the loss of 1,300

## REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002

### 7. Internal Audit: Annual Report, 2001-02 (Cont'd)

hours. To deal with the problem, the Department had engaged contract auditors to provide 1,000 hours of work, but such auditing was more costly and (owing to a lack of familiarity with the University) less efficient.

Mr. Britt referred members to the appendix to the report, which outlined the business risk model that was used to develop a checklist for reviews and discussions with units. Where reviews showed non-compliance with policies and procedures or unmitigated risk, the matter was drawn to the attention of the unit management and was reported to senior University management.

The nature of the risks found in the reviews was described on pages 4 - 5 of the report. The findings did identify some significant residual risk at both the divisional and central administrative levels relating to internal-control systems and compliance with policies and procedures. In all cases, however, the risks were considered significant only to the individual units, and the management of those units had in all cases been responsive and had either implemented improvements or undertaken to do so. There was, therefore, no need for attention by University management or the Audit Committee.

Mr. Britt distributed to members the Review Effectiveness Questionnaire completed by unit management at the end of the audit process. It was intended to help the Department to improve its performance.

Among the matters that arose in discussion were the following.

**(a) Joker's Hill.** In response to questions about the audit finding, Ms Brown said that Joker's Hill was an estate near King City that had been the extraordinarily generous donation of Drs. Murray and Marvella Koffler. The annual operating cost of the estate was about \$300,000. The original intention was to use a substantial part of the property for teaching and research in ecology and to sell off another part in order to establish an endowment that would generate revenue to cover the operating costs. Following a review, the University had decided that it would be best at this time to keep the property intact, meaning that there was need (a) to establish a budget to cover the operating cost, and (b) to identify a source of funding for a deficit that had accumulated over the past few years or to write that deficit off, adding it to the University's overall operating deficit. Because the largest number of beneficiaries of the site were faculty and students in the Faculty of Arts and Science, the Dean of that Faculty had been given principal responsibility for its administration. Funding would, however, be identified not only by the Faculty of Arts and Science but also by other faculties using the property and by the central budget process.

**(b) Administrative accountability reports.** A member noted that the level of non-completion of administrative accountability reports among departments reviewed by Internal Audit during the year had increased from 10.7% to 20.6%. In a highly decentralized operation, and in a situation of limited internal audit staffing, the sign-off of accountability reports was particularly important. So high a level of non-compliance was not comprehensible to outside business people.

Mr. Britt replied that when the matter was discussed with the unit heads, they usually moved quickly to have all appropriate accountability reports signed. He noted that two thirds of the increase in non-compliance arose from two departments that had been reviewed in the Faculty of Medicine. In those cases, principal investigators (lead researchers who held research grants) frequently held their primary appointments in a hospital along with University cross-

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****7. Internal Audit: Annual Report, 2001-02 (Cont'd)**

appointments, and they worked in laboratories located in the hospitals. Because their research grants were made to the University, however, the University was accountable for the funds and University procedures had to be followed. Ms Brown described the steps taken by the Vice-President and Provost to encourage compliance with the accountability-report process. Those steps included communications to Principals and Deans and discussion of the requirement at meetings of Principals and Deans. The Provost had made it clear that principal investigators who did not complete accountability reports risked the loss of signing authority on their grant accounts.

**8. Internal Audit Plan, 2002-03**

Mark Britt reported that the plan provided for 9,000 direct audit hours. The Department had been exempted from future base-budget reductions, meaning that the plan could be based on the assumption of a staff of eight. With some changes in emphasis, the plan was consistent with the approach used in 2001-02. Most time would be devoted to departmental audits and continuous auditing. Based on experience in 2001-02, the time budgeted for special reviews had been reduced somewhat. Similarly the time budgeted to assist the external auditors had been reduced, reflecting the Province's decision not to require an audit of Ontario Student Assistance Program awards in 2002-03. Time had been budgeted as well for information-systems reviews, follow-up reviews and completion of the three audits in progress at year end.

Mr. Britt described the methodology used to select departments for audits and responded to questions about that methodology. Selection was based on the risk rankings emerging from the Department's risk-self-assessment database and from the risk-assessment profile that had been completed and presented to the Committee in 2001. Departments had been selected on all three campuses and included academic, administrative and student-service units.

Discussion focused on the adequacy of the plan, which was constrained by staff limitations. Several members expressed the strong view that the intervals between reviews of high-risk units was too long. Two members stated that the length of the cycle for audits of high-risk units would not be acceptable in the private sector. Mr. Britt said that the matter had been considered at the highest levels of the University's administration. Following the Chair's discussion with the President about a year ago, and following Mr. Chee's appointment, Mr. Britt had met with Mr. Chee. With the support of Mr. Chee and Mr. Charpentier, the Department had requested funding to enable the appointment of two additional senior auditors. It had also requested one-time-only funding to enable auditors to have access to more information on-line so that they could complete parts of their reviews in a more automated manner. The request was, however, only one of many competing requests for important needs in a situation of limited funding. Some one-time-only funding had been provided, which would enable units to submit risk-assessment information on-line, and the Department had been exempted from future base-budget reductions. But, no additional base-budget funding had been supplied.

Asked to comment, Mr. Bowman said that internal audits continued to find violations of policies and procedures and some malfeasance, but none had been greatly costly to the University. Moreover, potential costly problems would not likely be prevented by more internal auditors. The University's Internal Audit Department was highly professional, and provided excellent value for the money allocated to it. Therefore, further allocations would not provide a good financial return on the investment. Ms Brown added that the exemption from further reductions represented a very good outcome in the current financial circumstances, demonstrating that the Committee's concerns had been heard. The exemption from reductions,

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****8. Internal Audit Plan, 2002-03 (Cont'd)**

combined with the selection of units by Mr. Britt's excellent risk-ranking system, the continuous auditing of selected transactions in all units, and the improvements in training, all meant that there was reason for confidence that the situation was well in hand.

The Chair agreed that there was no cause for alarm and that progress had been made over the years with improved training, the initiation of accountability reports, and the high level of productivity of the Internal Audit Department. Nonetheless the Chair and several members continued to express the strong view that the cycle for reviews of high-risk units was unacceptably long. The Chair was concerned that the University would move to remedy understaffing in the Department only after some major problem had occurred. It was generally AGREED that the Committee express its view that the Internal Audit Department should be allocated the resources required to reduce the cycle for reviews of high-risk units.

**9. Audit Committee: Revised Terms of Reference - Revisions**

Mr. Charpentier said that the Office of the Governing Council had been charged with the responsibility of reviewing the terms of reference for all of the boards and committees of the Council. There were several motivations for the review. First, the terms of reference should make the operations of the boards and committees more transparent and accessible, enabling readers to understand the processes followed. Second, the terms of reference should take into account policy changes over the past few years. Third, the terms of reference should better reflect new government requirements, such as the requirement that the governing body review annual reports on performance indicators. Fourth, the terms of reference should better reflect current practice, interpretations and expectations. With respect to the Audit Committee terms of reference, many of the changes were editorial in nature or were intended to bring the document into conformity with the standard format of the terms of reference of the other boards and committees. For example, the information on *ex officio* membership, appointment of members, appointment of the Chair and Vice-Chair, and the establishment of the agenda were all included in the Governing Council by-law or in other policies, but they were added to the terms of reference for the sake of completeness. There were also a number of substantive changes in the proposal, involving added responsibility for the Committee. If the new terms of reference were approved, the Committee would be charged with responsibility for:

- reviewing an annual risk assessment and monitoring the University's processes for identifying and controlling risk;
- periodically reviewing budget controls and procedures for reporting major variances to the appropriate committee of the Governing Council;
- annually reviewing a report of legal services in order to monitor possible risk exposures and contingent liabilities; and
- receiving reports on the occurrence and outcome of significant audits of University operations or projects carried out by external bodies such as government agencies.

The objective at this meeting was a review and discussion of the proposed, revised terms of reference and advice on their improvement.

The Chair observed that one item in the current and the proposed terms of reference might require more consideration. The first of the "areas of responsibility" listed in section 5.1.

**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002****9. Audit Committee: Revised Terms of Reference – Revisions (Cont'd)**

included the statement, “assesses the adequacy of public disclosure of financial information.” It would be important to clarify the meaning of the term before continuing to enshrine it in the terms of reference.

Discussion focused on the proposed responsibility for reviewing budget controls and reporting major variances. A member supported the proposal that the Committee review budget controls. He asked (a) whether the Internal Audit Department reviewed those controls, and (b) how major variances were reported at the present time.

Mr. Britt replied that his Department had recently completed a review of the planning and budget area and had found no significant deficiencies. On the contrary, the outcome had been one of the Department’s cleanest audit reports. Ms Brown said that the administration recommended the operating budget to the Planning and Budget Committee of the Academic Board, which in turn recommended it to the Academic Board. Those committees were the governance bodies responsible for resource allocation. The Business Board was then asked to review the budget to advise the Governing Council with respect to the fiscal responsibility of the budget. The Governing Council then considered the budget for final approval. With respect to variances, the administration had the authority to approve changes to the operating budget and changes to the authorized spending on capital projects within certain limits specified in Governing Council policies. Any changes in excess of those limits required governance approval. An annual operating fund forecast was prepared for the Business Board each spring.

The Chair noted that the University’s annual income and spending was highly seasonal, and there was therefore only an annual budget; it would not be possible to review quarterly reports. There were very good controls in place over spending. The major variances tended to be on the revenue side.

One member thought it would be helpful for the Committee to understand the University’s budget controls and that a periodic review of budget controls should be a part of the Committee’s mandate. Another observed that the Committee’s role would be a limited one and questioned whether its review of budget controls would add much value. The Chair suggested that the role would indeed be a limited one. The Committee was not involved in the budget process and should certainly not be second-guessing resource allocations. Moreover, short of members’ attending the relevant meeting of the Business Board, the Committee would not have an opportunity to come to understand the budget process at all well. It would, nonetheless, be worthwhile to carry out the limited responsibility of reviewing the budget controls to ensure that satisfactory processes were in place and were being carried out.

Invited to comment, Mr. Bowman thought that the proposed terms of reference covered all appropriate areas. He did not think that much would be gained by involving the Committee beyond its current mandate in reviewing budget controls.

Given the late hour, the Chair invited members to convey any further detailed comments to the Secretary of the Governing Council or to the Secretary of the Committee. A revised draft of the terms of reference would be distributed for the next meeting, and the Committee would be asked to consider it for recommendation to the Business Board, from which (assuming the Board’s endorsement) it would proceed to the Governing Council for approval.



**REPORT NUMBER 64 OF THE AUDIT COMMITTEE - May 22, 2002**

**10. Date of Next Meeting**

The Chair reminded members that the final regular meeting of the academic year was scheduled for Wednesday, June 19 at 5:00 p.m. The major item of business would be the review of the audited financial statements.

**11. Private Meeting with the Internal Auditor**

The Chair noted that the Committee held an annual, *in camera*, private meeting with the Internal Auditor with no member of the University's administration present. At the meeting, Mr. Britt would be invited to state "whether adequate cooperation has been received from management and whether management has exerted any undue pressure." [Terms of Reference of the Audit Committee, item 6.] Mr. Britt would also be invited to bring to the attention of the Committee any other matters he deemed appropriate.

THE COMMITTEE MOVED *IN CAMERA*

The Committee completed its private meeting with Mr. Britt.

THE COMMITTEE CONCLUDED ITS *IN CAMERA* SESSION

The Chair reported that there were no matters arising from the *in camera* meeting with the Internal Auditor that would require action.

The meeting adjourned at approximately 8:30 p.m.

\_\_\_\_\_  
Secretary

\_\_\_\_\_  
Chair

June 11, 2002