UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 68 OF THE AUDIT COMMITTEE

May 21, 2003

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, May 21, 2003 at 5:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. Robert S. Weiss (In the Chair)
Mr. George E. Myhal (Vice-Chair)
Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. Richard Nunn
Mr. Roger P. Parkinson
Professor Gordon Richardson

Mr. Felix Chee, Vice-President, Business Affairs*

Ms Sheila Brown, Acting Chief Financial Officer*
Mr. Louis R. Charpentier, Secretary of the Governing Council*
Mr. Mark L. Britt, Director, Internal Audit Department

Secretariat:

Mr. Neil Dobbs*
Mrs. Beverley Stefureak*

Regrets:

Mr. Gerald A. Lokash
Ms Kim McLean
Mr. Edward Ng

In Attendance:

Mr. Keith B. Bowman, Ernst & Young
Ms Diana Brouwer, Ernst & Young
Mr. Eric Fleming, Director, Risk Management and Insurance**
Mr. Pierre Piché, Acting Controller*
Ms Julianna Varpalotai-Xavier, Chief Operating Officer, University of Toronto Asset Management Corporation***

* Absented themselves for the consideration of item 14.
** In attendance for item 5.
*** In attendance for item 4.

ALL ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION

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REPORT NUMBER 68 OF THE AUDIT COMMITTEE – May 21, 2003

1. Report of the Previous Meeting

The confidential Attachment 1 to Report Number 67 (November 27, 2002) was amended. That attachment contained the report of the Committee's review of the Risk-Assessment Profile. The penultimate paragraph on page 2 contained a record of a member's comments about reputational risk. A new penultimate sentence was added to that paragraph, "The member suggested the inclusion in the risk assessment of teaching quality, which was important for the retention of students."

Report Number 67, as amended by the correction to the confidential attachment, was approved.

2. Financial Administration: Interim Organizational Arrangements

The Chair invited Mr. Chee to report on interim organizational arrangements during the period in which he would serve as President and Chief Executive Officer of the University of Toronto Asset Management Corporation (UTAM). Mr. Chee said that during that period Ms Brown would serve as Acting Chief Financial Officer, with Mr. Piché serving as Acting Controller. That had been the organizational arrangement for the interim period between the retirement of Mr. Robert G. White as Chief Financial Officer and the appointment of Mr. Chee. In other aspects of his portfolio, Mr. John Bisanti (Chief Capital projects Officer) and Ms Catherine Riggall (Assistant Vice-President, Facilities and Services) would in general report directly to the President, although Mr. Chee would be available for a part of his time to carry out duties other than heading UTAM, and he would retain overall broad responsibility for his full portfolio. In response to questions, Mr. Chee said that he was assessing the situation at UTAM before the initiation of a search for an on-going head of that organization. He anticipated that the matter would be resolved by the middle of the calendar year.

The Chair expressed his confidence that Ms Brown and Mr. Piché would be well able again to guide the University's financial affairs capably. He was, however, concerned that Mr. Chee had undertaken a number of initiatives, and he already had a daunting load of responsibilities before taking responsibility for UTAM. He asked that all University officers notify the Committee or the Chair if the interim organizational arrangements were causing a situation of undue risk.

3. Business Arising from the Report of the Previous Meeting

The Chair directed members' attention to the table of follow-up items, attached to Report Number 67. He noted that dealing with a number of these items, in particular taking steps to mitigate certain risks, depended on the outcome of budget discussions. The Chair invited Mr. Chee to report. Mr. Chee said that the current year's budget had required that all units make a budget reduction of 4.46%. Consequently, it would be necessary to prioritize the steps required to mitigate the risks reported in the risk-assessment profile. Notwithstanding the budget reduction, the need to deal with those risks still remained on the administration's list of priorities.

3. Business Arising from the Report of the Previous Meeting (Cont'd)

Mr. Charpentier reported with respect the Committee's proposal that action be taken to improve the level of support to the Internal Audit Department to enable that Department to carry out at least an annual review of all budget units classified as high risk. Current efforts were focused on restoring the Department's budget to the level before the 4.46% budget reduction. Mr. Charpentier had discussed the matter with the President, who had indicated support for the restoration, and Mr. Charpentier was currently working with the Provost, as chief budget officer, to find a means to implement the restoration.

Mr. Charpentier noted that he was responsible for dealing with one area of risk mitigation: contract risk. He had been away from the University for some weeks early in the year. He did, however, anticipate bringing to the Executive Committee of Governing Council, before the end of the governance year, a proposal to strengthen the Policy on Approval and Execution of Contracts and Documents.

Mr. Chee reported that the Business Board had considered the matter of deferred maintenance. The administration had made a commitment to funding, not in the 2003-04 budget, but in the forthcoming long-range budget plan, to ensure the level of maintenance that would at least prevent further deterioration. He noted that other items in the risk assessment would arise throughout the year in various different forms. It was clear that the risk-assessment profile had brought about a better appreciation of risk management in the University.

The Chair appreciated that the matter was being kept on the table during a period of such great financial stress. The Robarts Library fire risk had not yet been dealt with owing to financial constraints. The matter of contract risk was being deal with. It was unclear at this time whether progress had been made in preparing plans for any computer disaster recovery. Risk with respect to the construction program had been addressed, with more information being provided to the Business Board both in regular reports and in the special report on deferred maintenance. Action was being taken with respect to asbestos. Mr. Chee was moving decisively to deal with investment risk, currently devoting most of his time to UTAM. The Chair concluded that the University was moving forward with its risk-management program.

A member suggested that the Committee give consideration to its responsibilities with respect to financial controls in the new environment brought about by changes in the United States in response to the accounting scandals in that country. For example, chief executive officers and chief financial officers were now required to certify their corporations' financial statements. The member urged consideration of the Committee's responsibility with respect to the particular control problems caused by the University's decentralized administration. The Chair indicated that he planned to ask the Committee to consider just such questions under the "Other Business" item on the agenda. Mr. Chee observed that the requirements of the Sarbanes / Oxley legislation in the United States were probably inappropriate for implementation in the case of the Governing Council of the University, a body consisting largely of volunteer members.

4. University of Toronto Asset Management Corporation: Financial Statements, 2002

The Chair said that, although he had asked that UTAM's full annual report be distributed, the Committee was charged to review only the financial statements. UTAM was classified as an "incorporated business ancillary operation," like the University of Toronto Press and the Innovations Foundation. However, unlike the case with those other ancillary organizations, the Business Board had not asked the Audit Committee to monitor the substantive work of UTAM. The Business Board had itself retained the responsibility to monitor investment performance. The annual report had been submitted to that Board and it had been discussed at length. The Board had accepted UTAM's annual report, subject to this Committee's review of the financial statements.

Ms Brown noted that the statements for the year ended December 31, 2002 covered UTAM's second full year of operations. The corporation had been established in May 2000. It was a $3.7-million operation. The University's and the pension plans' assets were not reflected in the UTAM statements.

Questions and discussion focused on the following matters.

(a) Expenses: telecommunications and technology. A member observed that expenses for telecommunications and technology had increased sharply from $168,000 to $456,000. Ms Varpalotai-Xavier replied that the increase had been brought about by three factors. First, UTAM had purchased new software that would enable it to carry out performance measurement in house. Second, it had begun participation in a data-mart service provided by State Street, which would allow UTAM to automate many of its back-office functions, enabling UTAM staff to focus on more value-added tasks. Third, it had paid the cost of a full year of subscription to the Bloomberg service that enabled the processing of in-house transactions.

(b) Deferred compensation. The Chair asked why deferred incentive compensation earned in the current year, even though not yet vested, was not recorded as a charge in the current year. Mr. Bowman replied that the accounting treatment used by UTAM was appropriate under Generally Accepted Accounting Principles. Deferred compensation should not be regarded as a liability until it has been earned. For example, the previous President and C.E.O. did not quality to receive the deferred portion of his incentive compensation when he resigned and moved to another position. Mr. Chee observed that the UTAM Compensation Policy was currently under review.

(c) Management of the assets. In response to members' questions, Mr. Chee said that he was currently working with consultants to review the asset mix in the endowment funds. A special meeting of the UTAM Board had been arranged in June to consider a proposal that would be forthcoming to revise the asset mix. The decision about asset mix might then drive other decisions concerning the management of the funds. The Investment Policy for University Funds, in effect until April 7, 2003, had called for a normal asset mix of 80% equities and 20% fixed-income securities. In reality, those categories contained further specifications, and Mr. Chee would recommend that a more representative asset mix be specified in the service agreement

4. University of Toronto Asset Management Corporation: Financial Statements, 2002 (Cont'd)

between the University and UTAM. The asset categories would likely be: Canadian equities, U.S. equities, Non-North-American equities, absolute-return funds (a category of hedge funds), real assets, private-equity investments and fixed-income investments. Those were the categories being used in the study now underway to determine the appropriate asset mix for the return objective and risk tolerance of the endowment funds. Once that normal asset mix was put into place, UTAM would formulate a medium-term view of the world and make judgements whether the current external portfolio managers would manage the assets consistency with that view. Mr. Chee was confident that the staff at UTAM would be well able to manage the assets. While the asset mix contained in the service agreement would be more specific, the UTAM Managing Directors were currently overseeing all of the asset classes. Mr. Chee stressed that apart from fixed-income securities, virtually all of the assets were being invested by external portfolio managers. UTAM's job was to determine which asset classes should be in the funds and in what proportion, to decide which external portfolio managers would be best to manage those asset classes, and to monitor and evaluate their performance.

(d) Pension fund. A member asked whether, because of the very weak securities markets over the past three years, the surplus in the pension plans had been eroded. Mr. Chee said that an erosion typical of all defined-benefit pension plans had taken place at the University. The next annual actuarial valuation would provide a specific statement of the surplus or deficit as at June 30. The valuation assumed a return on assets of 7% per year, which was conservative relative to other plans. The Chair observed that the matter could be considered further in the item dealing with the notes to the financial statements, which included a note on employee benefit plans. That note stated the assumptions concerning the discount rate for the liability of the plans as well as the expected long-term rate of return on the plan assets.

On the recommendation of the Acting Chief Financial Officer,

YOUR COMMITTEE ACCEPTED

The audited financial statements of the University of Toronto Asset Management Corporation, December 31, 2002.

5. Risk Management and Insurance: Annual Report

The Chair recalled that an annual report on risk-management and insurance had for many years been submitted to the Business Board. One year ago, Mr. Chee had proposed that, given the Audit Committee's new responsibility for monitoring risk management generally, it would be useful for the Committee to review the annual report on Risk Management and Insurance in order to be aware of what risks were insured and to be familiar with that aspect of the University's risk-management activities led by Mr. Fleming.

5. Risk Management and Insurance: Annual Report (Cont'd)

Ms Brown reminded the Committee that the University participated in a self-insurance reciprocal with most other Canadian universities. This was a particularly difficult time in the insurance industry, and the University anticipated that it would be required to pay substantially higher premiums over the next year or two.

Mr. Fleming reiterated Ms Brown's statement that this was a difficult time in the insurance industry. For example, notwithstanding a good claims record, the insurer of the University's vehicle fleet had increased rates by 45%, but it had sought to placate the University by providing assurances that the increase for the coming year would be limited to 15% - still an increase far in excess of the rate of inflation. Vehicle fleet insurance was, moreover, one of the less problematic areas. The difficulties in the insurance market had been driven by events that were beyond anyone's control: global conflicts, declining equity markets, and other elements of bad news. The University had been able to continue its core coverage with only some erosion, for example the exclusion of loss caused by terrorism. In addition, premiums were increasing substantially, and the Canadian Universities Reciprocal Insurance Exchange (CURIE) was experiencing problems with respect to re-insurance.

Mr. Fleming responded to a number of questions.

(a) General insurance structure. The report covered the period ending with the April 30 end of the fiscal year, and the diagram outlining the general insurance structure showed the insurers in place during the largest part of the 2002-03 year. Some of those insurers had changed as of January 1, 2003. That had been the case with respect to one of the companies used to provide an "umbrella" liability policy; that umbrella policy would cover losses in excess of those covered by the University's general liability, errors and omissions, and automobile policies. The company formerly known as Gerling Global had experienced financial difficulties in Europe and had been restructured into three parts. The Canadian business was now called Gerling Canada. The new company had been refinanced and was now an A-rated insurer. Mr. Fleming would update the diagram to show the insurers currently in place. He would distribute the revised diagram to members of the Committee and use the revised version henceforward, including it in the report to the Business Board.

(b) Property insurance and loans for building projects. Ms Brown noted that most of the financing for building projects, including the recent $160-million debenture issue, was based on the general credit of the University and was not secured by mortgages on specific properties. A couple of old buildings were so secured.

(c) Deductibles and premium costs. Mr. Fleming did not think it would be possible to seek reduced premiums by accepting increased deductibles. Using its self-insurance reserve, the University had already accepted the maximum deductibles permitted by CURIE.

(d) Directors and officers liability insurance was included in the coverage described as "errors and omissions liability."

5. Risk Management and Insurance: Annual Report (Cont'd)

(e) Robarts Library coverage. In response to a question, Mr. Fleming said that the Robarts Library building and contents were valued at $1.5-billion. The maximum property insurance available was $650-million. A member observed that the insured value would presumably increase each year as the Library added to its collections. In a discussion of the matter, several members noted that the problem of this uninsurable risk had been considered in the risk-assessment exercise, and they urged that the University proceed with action to install a sprinkler system to protect the library or to take such other action as installing fire containment separations within the building. One member urged that creative means of financing such steps should be used if necessary. For example, it might be appropriate to devote some of the money now budgeted for acquisitions to begin protecting the collection already in place. Mr. Chee and another member noted that any loss, while possibly catastrophic, would not likely involve the loss of the building itself as well as all of the contents. Mr. Chee observed that retrofitting a sprinkler system would be very expensive and there were problems with sprinkler systems in libraries, given the cost of potential water damage to the books. Nonetheless, it was essential that the University reach a decision and commence action with respect to this matter.

(f) Canadian Universities Reciprocal Insurance Exchange (CURIE). The Chair observed that CURIE enabled the member universities to spread risk but it also required that they take on risk for losses at other universities. He asked whether the University might at some time conclude that it was not advantageous to participate in CURIE. Mr. Fleming replied that universities made a five-year contractual commitment to remain in CURIE. There was a six-week window just before the end of the five-year commitment period in which a university could advise CURIE of a decision not to continue. The University had in fact renewed its commitment to CURIE in January 2003. The University was pleased with CURIE. Until the past two years, CURIE had been able to provide premium rebates to member universities. Although it was not now in a position to do so, requiring the full amount of its reserves for potential claims, the member universities fared better as a part of a large consortium than they would individually in dealing with the vagaries of the current insurance market.

(g) Self insurance reserve: $2,500 deductible. The Chair asked whether there was a process for reviewing the deductible amount paid by budget units that incurred losses before those losses were covered by the self-insurance reserve and the University's insurers. Mr. Fleming replied that the matter was reviewed regularly. The deductible of $2,500 would represent a significant proportion of the discretionary element of the budget of a small unit. Increasing the deductible would be perceived by many divisions as the central administration's leaving the division unprotected on its own. While it might be argued that the deductible should at least be increased to keep pace with the increase in the consumer price index, the cost of many electronic items, which represented the most frequent losses, was in fact declining. Mr. Fleming did assure the member, however, that the matter would continue to be kept under review.

(h) Thefts. A member asked whether, given the losses of electronic equipment, it would be appropriate to undertake a major initiative against theft. Mr. Fleming replied that many steps had indeed been undertaken, including cabling and locking devices, placing valuable equipment in security cages bolted to buildings, and even video surveillance. Those measures had not, however, been sufficient to deter thefts in all cases.

6. Audited Financial Statements: Draft Format for the Statements and Draft Notes

Ms Brown said that the Committee would consider the financial statements twice: at this meeting and at the meeting of June 18, 2003. At this time, the Committee was invited to consider proposed changes to the format of the statements and the draft notes to the statements. Ms Brown reviewed the major changes to the format.

- **Balance sheet**. The assets and liabilities had been classified into long-term and short-term. This classification frequently appeared in university financial statements, but it would be new for the University of Toronto.

- **Statement of operations**. The line titled "revenue less expenses" was now titled "net loss." The material that had previously appeared below the "revenues less expenses" line (which material had been entitled "statement of changes in deficit") had been removed. This material had been repetitive because it also appeared in statement 3, "statement of changes in net capital."

- **Terminology**. What was previously called "net assets" was now to be called "net capital." For the sake of clarity, the net capital was divided into four categories: unrestricted capital (deficit); committed capital; equity in capital assets; and endowments. The committed capital was that committed in special funds such as that to match the University's liability under the Supplemental Retirement Arrangement. A member asked why the term "net capital" was used rather than simply "capital." Mr. Chee replied that he would be pleased to use the term "capital." His major concern was to call the University's "net loss" a loss rather than to describe the loss as "revenues less expenses," providing a negative figure. With respect to the statement of changes in net capital, the objective of the statement was to make it clear that that the University did not have any free capital – that its assets were all either tied up in physical assets, endowments or committed funds.

Ms Brown outlined the changes to the notes. Among other changes, the changes to the format caused a ripple effect of changes to the notes.

- **Note 1(h), Summary of significant accounting policies and reporting practices: Accounting estimates**. This new disclosure made it clear that the financial statements included amounts based on management assumptions and estimates, which were in turn based on management's best knowledge of current events and actions that the University would undertake in the future.

- **Note 12, Endowments**. The note had been expanded to describe the change to the endowment payout. The endowed funds were invested in units of the Long-Term Capital Appreciation Pool. For many years, the payout had been 5% of the average market value of the units over the trailing 48 months. The administration had undertaken a substantial study of the payout and had concluded that it required an investment return that could be

6. Audited Financial Statements: Draft Format for the Statements and Draft Notes (Cont'd)

achieved only with an investment policy that involved too high a level of risk. The payout had therefore been changed to 4% of the market value of the unit as at November 2002. Subsequent payouts would be increased annually at the rate of inflation. In future years, therefore, the annual payout would cease to be determined directly by the short-or medium-term performance of the securities markets. That change would be described not only by the expansion of note 12, it would also be explained in the "Financial Highlights." In response to questions, Ms Brown said that the change would mean a substantial reduction in the payout. The previous payout was $9.36 per unit. The new payout would be $6.60 per unit to be increased annually by the rate of inflation. The study that had been completed of the endowment payout demonstrated that it would be appropriate to reduce the real investment-return objective to 4% per year above inflation. That objective would permit a more conservative investment policy that would reduce risk and reduce the volatility of returns. In response to other questions, Ms Brown said that basing the payout on the average value of the unit over four years had moderated the payout relative to investment returns in good years but it had the reverse effect in poor years. The new payout practice also included a corridor; if the earnings of the endowment funds proved to be more than 5% or less than 3%, then the 4% payout would be increased or reduced accordingly.

- **Note 16, Government and other grants for restricted purposes**. The note was a new one. The University could record government and other grants for restricted purposes as revenue only when the amount was actually spent for the restricted purpose. The objective of the new note 16 was to disclose the total amount of government and other grants for restricted purposes received during the fiscal year, whether or not it was spent during the year on the restricted purpose.

- **Note 18(b), Other commitments**. The note disclosed the significant commitment to purchase the Colony Hotel for $66.4-million – a purchase that was scheduled to close in the 2003-04 fiscal year.

Among the matters that arose in discussion were the following.

(a) Funding for student assistance. In response to a member's question, Ms Brown noted that the statement of operations showed an expense of $86.7-million in 2001-02 for scholarships, fellowships and bursaries. That line did not include the full amount for graduate student funding packages, which included payment for teaching assistantships and research assistantships. That spending was reported under salaries. Information about student aid was provided in the "Financial Highlights" at the beginning of the financial statements package.

(b) Note 17, University of Toronto Foundation. A member observed that as at the end of the 2002 fiscal year, the University of Toronto Foundation had a balance of donations on hand of only $800,000. That appeared to be a trivial amount for a separate note disclosure. Ms Brown

6. Audited Financial Statements: Draft Format for the Statements and Draft Notes (Cont'd)

and Mr. Charpentier reported that the University and several other Ontario universities were in the process of winding up their crown foundations because they were no longer required to provide tax advantages for certain major donations.

(c) Note 3, Employee benefit plans. In response to questions, Ms Brown said that the Committee would in a meeting in the fall receive the annual report on the pension plans. That report included audited financial statements and a summary of the actuarial valuation. The pension plans' fiscal year ended on June 30. The University's fiscal year ended on April 30, and the disclosures in the financial statements were calculated as at April 30. The pension-plan assumptions for the financial statements included management's best estimates of the expected long-term rate of return on the pension plans' assets, the rate of compensation increase, and the appropriate discount rate to determine the present value of the plans' liabilities. Those assumptions were reviewed annually on the basis of: advice from the actuaries, a review of the assumptions adopted by other organizations, and advice from the auditors. For the 2003 statements, the estimated discount rate was 7.0%, the estimated long-term rate of return on pension plan assets was 7.0%, and the estimated rate of compensation increase was 4.5%. Those estimates were within the ranges suggested by both the actuaries and the auditors, and they were more conservative than those used by many other organizations.

The Chair noted that recent changes to the Investment Policy for University Funds and the reduction of the payout from the University's endowment, as well as press reports of problems in many pension plans, meant that there would be a high level of scrutiny of this element of the financial statements. A member observed that the University had not in recent years achieved the 7% assumed rate of return on plan assets. Ms Brown stressed that the assumption was for the long term. The management estimates were conservative, being at the low end of the range adopted by other employers. She observed that there had been considerable pressure to use higher estimates during the middle and late 1990s when the returns provided by the capital markets were unusually high. The University had resisted those pressures and had maintained a reasonable, long-term view. This was a similarly unusual period of negative returns, and it would make sense to continue to maintain a reasonable, long-term view.

Ms Brown continued that the key figure with respect to the rate of return on assets was the real return, after the effect of inflation. The anticipated real rate of return was 4%, with a further 3% nominal return being required to match the projected annual rate of inflation. That was similar to the real return anticipated for the endowment funds under the new payout policy.

Mr. Chee stressed that the anticipated deficit in the pension plans in the next valuation should be regarded not as the outcome of faulty long-term assumptions but rather as the outcome of several years of employer and employee contribution holidays as well as improvements in pension benefits. The employer contribution holiday was required by the Income Tax Act, which prohibited further contributions to pension plans that enjoyed an "excess surplus." However, had those contributions continued and had the monies been set aside in reserves, those reserves

6. Audited Financial Statements: Draft Format for the Statements and Draft Notes (Cont'd)

would have been adequate to deal with the three years of negative returns from the equity markets. Therefore, changing the assumptions at this stage would make them incorrect ones.

Invited to comment, Mr. Bowman and Ms Brouwer said that the University's assumptions were reasonable and within the usual range. Differences among assumptions were usually no greater than 1% to one-half of 1%. For example, the range of acceptable discount rates to determine the present value of a pension plan's liability was 6% to 8%. The University's assumption of 7% was right in the middle.

A member asked about the University's strategy for dealing with the likely deficit in the pension plans. Ms Brown replied that there would clearly no longer be an "excess surplus" in the plan, defined as one of more than 10% of the accrued liability or two years' current service cost. Therefore, the University would resume contributions. If there was an actuarial liability as at the July 1 valuation, then the University would also be required to make additional contributions of an amount that would amortize the liability over fifteen years. If there was also a solvency deficit, i.e. if the assets of the plan were less than the liability if the plan were wound up as of the valuation date, then the University would be required to make additional contributions of an amount that would amortize that liability over five years. Substantial modeling was being carried out with scenarios involving various rates of investment returns. The outcome would appear in the long-range budget plan to be presented to the Governing Council in the fall. Mr. Chee assured the Committee that he would not support any budget outcome that involved minimizing employer contributions through the adoption of unrealistic assumptions, for example of a nominal return on assets of greater than 7% per year. If actual investment returns exceeded the reasonable assumptions adopted, that would be all to the good.

A member suggested, and the Chair endorsed the suggestion, that the administration prepare a written explanation, in terms that would be understandable to a layperson, of the situation of the pension plans and of the University's strategy with respect to those plans. Such a document should be available for release at the time the financial statements become public.

7. Administrative Accountability Reports: Annual Report on the Program, 2001-02

Ms Brown said that the program of annual administrative accountability reports had now become well established within the University. The reports were completed each spring, and the process for 2003 was in fact now underway. For 2002, the process was complete, and members had received a copy of the President's accountability report which stated that he had received reports from all of the Vice-Presidents and all other officers reporting to him and that he had acted upon any irregularities or breaches of policy. The program was clearly reaching maturity. The remaining challenge was at the level of the individual budget units to ensure completion of reports by all employees having financial responsibility. That often involved making employees with limited financial responsibility aware that they were expected to complete a report. The forms used for reporting in various categories of positions were available on the web for members' review. They were very similar to those used in previous years.

7. Administrative Accountability Reports: Annual Report on the Program, 2001-02 (Cont'd)

In response to questions, Ms Brown said that some reports contained negative responses, indicated that that administrator had not carried out a particular responsibility. In some cases, the reports also contained the response "not applicable," particularly in the case of employees in non-financial positions who had limited financial responsibilities as part of their jobs. Mr. Britt assured the Committee that the Internal Audit Department did look into such negative responses. Ms Brown added that it was known that the investigation of negative responses was part of the internal audit process. Moreover, the signature of an accountability report by the officer at the higher level meant that the officer was aware of the negative response, had considered the matter and was assuming responsibility for the outcome of the negative response. A member observed that he was not confident that his colleagues on the faculty were always aware of the importance of completing these reports correctly. Ms Brown replied that the importance of the program was reiterated annually and strongly by the Provost at meetings of Principals, Deans, Directors and Department Chairs.

The Chair said that the program was a very important and valuable innovation at the University, and he stated that it was very important to continue to seek improvements in its implementation.

8. Internal Audit: Annual Report, 2002-03

Mr. Britt reviewed his report beginning with a reference to the departmental and continuous audits that had been undertaken or were in progress and special reviews that had been requested and were complete or in progress. Four departmental audits which had been planned for the past year had not been undertaken and two quarters of continuous audits had not begun. Only one of the four audits not undertaken was in a division considered as high risk in terms of its exposure to financial loss. It had been deferred because the division was adapting to a new budget model and had asked for the audit to be delayed. It would begin in September. The Audit Department had completed ten of the follow-up audits from the previous year and had assisted Ernst & Young with the 2001-02 and 2002-03 year-end audits.

Mr. Britt referred to his report and reviewed the hours and staff complement, noting that the actual 8,764 audit hours (versus the plan of 9,000) did not include hours spent on the business of University of Toronto Asset Management (UTAM), which were accounted for separately. He reviewed staffing issues and the uncertainty, with across-the-board budget reductions, of returning to a full complement. He referred members to page five of the confidential report for an outline of residual risks and Appendix 1 for a definition of each risk, noting that overall the types of residual risks were similar to those in prior years, were significant only to the unit audited, and were not such that they required the attention of the senior management of the University or of the Audit Committee. Audit recommendations included in the audit reports related primarily to improving existing controls, including segregation of duties and compliance with policies and procedures. Management of the units audited had implemented or indicated their intention to implement the recommendations included in the audit reports.

8. Internal Audit: Annual Report, 2002-03 (Cont'd)

With respect to administrative accountability reporting, Mr. Britt noted that the percentage for completion of reports had improved from the previous year. Where reports were not completed, the department head had been advised and all outstanding reports had subsequently been obtained.

Mr. Britt reported that his Department's auditing of UTAM had commenced in July on a cost-recovery basis, and reports had been issued in accordance with the audit plan approved by UTAM's management and audit committee. Audit findings related primarily to the lack of completeness and accuracy of documentation of certain decisions. UTAM management had already implemented or indicated its intent to implement most of the recommendations included in the audit reports.

In conclusion, Mr. Britt stated that audit results indicated that some financial management expectations had not been consistently met with respect to control and compliance. Weaknesses in the systems of internal control within some of the units audited increased the risk of inefficient and uneconomical procurement and use of resources, non-compliance with policies and procedures, and error, fraud and business interruption. Findings were symptomatic of the highly decentralised financial administration environment and indicative of the need for continued effort to refine and ensure adherence to University policies, procedures and accountability processes.

In response to a member's question, Ms Brown said that where risks were University-wide, they were identified in the risk-assessment profile. Risks identified in divisional budgets were small and were primarily the outcome of the turnover in academic leadership. To mitigate the division-level risks, more emphasis was being placed on training of academic leaders, and that emphasis would continue and expand.

Mr. Chee said that Mr. Britt's assessment was fair. This was an extremely decentralized environment which, from the perspective of controls, required good financial, administrative and academic systems. While there was increasing awareness of the difficulties inherent in a decentralized environment, continued work was needed. However, he had no major concerns.

A member asked what the relationship was between risk assessment by the Internal Audit Department and the risk assessment profile produced by Financial Services. Ms Brown responded that a key source of information for the latter was the self-assessment profile, out of which her Department tried to capture the level of risks associated with each department. Analyses of those assessments helped to identify the significant risks for the University as a whole, which then found their way onto the risk assessment profile. Mr. Britt added that when departmental audits were undertaken, attention was given to identifying both the detailed risk at the divisional level and the overall risks at the University level.

9. Internal Audit: Audit Plan, 2003-04

Mr. Britt reviewed the Audit Plan for 2003-04, commenting briefly on audit hours, staff complement, plan objectives and plan scope. The planned allocation of hours to each of the activities was noted on page 6 of the plan, which was provided to members in confidence. He also commented briefly on the risk assessment and selection of department audits which was detailed on page 7 of the plan.

A member asked if attention would be given to assessing any risk that might be associated with the high level of capital construction underway at the University. Mr. Britt replied in the affirmative and outlined the details of the audit approach in this area.

10. External Audit: Fees

Ms Brown reviewed the highlights of her memorandum of March 25 and indicated that she was satisfied with the proposed $110,000 fee for the basic operating fund audit for 2003-04. She also referred members to the survey of audit fees at other universities. Mr. Bowman was invited to comment and spoke briefly to the fee increase, noting that more work was being required and expenses had increased.

The Chair expressed his hope that the increased fee would allow a more detailed explanation by the external auditors of their approach to high risk areas, and he asked the auditors to review those areas with respect to the 2003 audit at the next meeting.

11. Report of the Administration

Mr. Chee, Ms Brown, Mr. Charpentier and Mr. Britt stated that there were no additional natters that should be drawn to the attention of the Committee at this time.

12. Date of Next Meeting

The Chair reminded members that the final regular meeting of the academic year was scheduled for Wednesday, June 18, 2003. The major item of business would be the review of the audited financial statements. It was proposed by the Chair and agreed that the meeting would begin at 4:00 p.m. to allow time for the Committee to consider its role and responsibilities in the light of recent developments affecting audit committees.

13. Other Business

The Chair indicated that he had hoped the Committee would have time to discuss its role, now that one year had elapsed since the terms of reference had been revised. However, given the time, he asked members' indulgence to have this discussion postponed to the next meeting, at which time a specific amount of time would be allotted for the Committee's self-examination and a look at how it compared with similar committees outside the University.

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The Chair noted that a report on deferred maintenance had been received by the Business Board, and that two revised policies on investments had been approved by the Board. He thought

13. Other Business (Cont'd)

both the report and the revised policies would provide good background information for the Committee, and he asked the Secretary of Governing Council if these could be shared. Mr. Charpentier agreed to provide those documents for the Committee's background information.

14. Private Meeting with the Internal Auditor

The Chair recalled that the Committee held an annual, 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 had been received from management and whether management had exerted any undue pressure. He would also be asked to bring to the attention of the Committee any other matters he deemed appropriate. In addition, Mr. Britt would be invited to report on three matters that had been the subject of special audits.

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 two matters of concern arising from the *in camera* meeting with the Internal Auditor.

(a) Budget reductions and the control environment. Mr. Britt had in his annual report and in his *in camera* report on special reviews pointed out problems arising from a number of failures in the operation of existing controls, including failures to segregate financial duties and to comply with policies and procedures. While he had characterized those problems as relating only to the units audited and as not requiring the immediate attention of senior management, the Committee was troubled that those problems might be exacerbated by the 4.45% budget reductions being required of all divisions. There was a real risk that such reductions could reduce the budget unit's opportunity to segregate incompatible financial duties and could place further pressures on administrative staff and academic administrators, leading to further failures to comply with such procedures as regular review of financial reports. It was important that units respond to budget pressures in a manner that would not jeopardize the University's responsibility for proper stewardship of public funds.

(b) Response to individual acts of wrong-doing. The Committee was concerned that the University and its divisions and departments, notwithstanding the difficulty of doing so, respond vigorously to defalcations by employees. After seeking legal counsel, the University and its officers should do everything possible in the case of a defalcations to terminate the employment of the individual for cause, to encourage criminal prosecution, and to give publicity to the

14. Private Meeting with the Internal Auditor (Cont'd)

incident to demonstrate that wrong-doing is found out and that the employee responsible does suffer appropriate consequences for the misdeed.

The meeting adjourned at 8:20 p.m.

Secretary | Chair

June 10, 2003

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