UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 69 OF THE AUDIT COMMITTEE

June 18, 2003

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 18, 2003 at 4:00 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. Gerald Lokash
Mr. Richard Nunn
Mr. Roger P. Parkinson

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:

Ms Kim McLean
Mr. Edward Ng
Professor Gordon Richardson

In Attendance:

Mr. Keith B. Bowman, Ernst & Young**
Ms Rosie Yeung, Ernst & Young**
Mr. Pierre Piché, Acting Controller*

* Absented themselves for the consideration of item 4.
** Absented themselves for the consideration of item 5.

ITEMS 3 and 5 ARE RECOMMENDED TO THE BUSINESS BOARD FOR ITS RECOMMENDATION TO THE GOVERNING COUNCIL

1. Report of the Previous Meeting: Report Number 68 - May 21, 2003

Report Number 68 of May 21, 2003 was approved.

26825
Note: Item numbers in this report correspond to those on the Committee's agenda.

2. Business Arising from the Report of the Previous Meeting

Mr. Chee noted that, with respect to asset management, the Business Board would be informed that the asset mix would now become the responsibility of the University of Toronto Asset Management Corporation (UTAM). A proposal for a revised asset mix had recently been reviewed by the UTAM Board and approved. The next step would be to establish benchmarks based on the new asset mix and incorporate those into the service agreement. He expected that all of this would be accomplished in about sixty days.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003

The Chair said that it was a truly remarkable accomplishment to have April 30 financial statements for so large and complex an institution ready for consideration at so early a date. He thanked and congratulated Mr. Chee, Ms Brown, Mr. Piché, Mr. Britt, Mr. Bowman and all of the members of their teams on their work. This achievement spoke well of their excellent approach and teamwork.

Mr. Chee reported that he had presented a financial forecast to the Business Board on March 3, 2003, which had proved to be reasonably close to the actual financial outcome for the year. The consolidated financial statements showed that the University had a major problem with respect to its revenues. It was important to understand the impact of the revenue shortfall on the balance sheet, which had shown a substantial decline in net assets or capital in 2001-02 and again in 2002-03. That capital consisted largely of the endowments and the capital assets, with very little discretionary capital. The University's revenue consisted of three types. The first was driven by student enrolment, where revenue from government operating grants and tuition fees increased with enrolment. On one hand, the University could decide to increase its enrolment and therefore its revenue. On the other hand, it could not readily increase its revenue per student, with the Government of Ontario resisting increases in operating grants and students resisting increases in tuition fees. The second type of revenue was event-driven, including donations and research grants. While the University was doing very well in attracting research grants, income from donations was volatile, depending to some extent on the strength of the financial markets. The third type of revenue was from investments, and this had been the most volatile of all sources. The University's problem was that it had to cover its fixed costs, including the salaries and benefits of its largely tenured faculty, and it did not have reliable revenue sources to do so. That made it very important to have capital available to absorb shocks. The structure of the University's costs made it very difficult to reduce its costs substantially relative to revenue. For example, increased enrolment meant increased revenue, but it also involved increased costs such as additional faculty to teach the larger numbers of students. The need therefore was to galvanize support for better public funding. That would not be an easy task. If the markets were to come back and investment income were to return to a solid level, it would be very important to build up reserves to absorb a future cycle of shocks.

Two members expressed concern with the observation in the *Financial Highlights* that over the past five years, expenses had grown at a compound rate of 9.9% whereas revenues had grown

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

only at 4.7%. It would be very important for the University to budget to break even, and even to earn a bit of a reserve, although that would be very hard to do. A large number of faculty were retiring, and the University was eager to replace them because engaging an excellent faculty was at the heart of the University's mission. On the other hand, it was essential to the long-term health of the University that the budget be in the black. The Chair and Mr. Chee noted that Governing Council policy did place constraints on the operating budget. That policy stated that the "surplus/deficit in respect of operating funds shall at each fiscal year-end be as close to zero as possible, with permissible variations ranging from +1½% to –1½% of operating income." The long-range budget guidelines approved by the Governing Council since 1991 had permitted larger variances during the six-year planning period on the understanding (a) that the cumulative deficit would return to within 1½% of income, and (b) that the annual budget would return to balance, both by the end of the planning period. Nonetheless, the decisions reflected in the budget did not ensure that the income statement would end up in the black. For example, if investments incurred losses, the outcome would be a larger-than-budgeted deficit.

Ms Brown added her thanks to her team as well as the internal and external audit teams for their efforts in bringing out the financial statements in record time. This achievement required an extraordinary number of extra hours' work by all concerned. The audit was a clean one, and the audit report unqualified. Ms Brown reviewed the highlights of the financial statements (attached hereto as Appendix "A") with the assistance of a PowerPoint presentation (attached hereto as Appendix "B"). She noted that the consolidated financial position and results were shown on the balance sheet, the statement of operations, and the statement of changes in capital, on pages 7, 8 and 9 of the *Financial Report*. The consolidated statements included the operating fund, the ancillary operations fund, the capital fund and the restricted funds (which included endowed funds, research grants, and funds for other restricted purposes). Much attention usually focused on the operating budget, and the results of the operating fund (as well as the other three funds) were broken out in Schedule 1 on pages 4 and 5 of the *Supplementary Financial Report*.
Ms Brown responded to numerous questions during the course of her presentation.

- **Results compared to forecast**. The reduction in the University's capital owing to the loss incurred in 2002-03 was $276.2-million, close to the forecast $267.1-million. According to Generally Accepted Accounting Principles (GAAP) for not-for-profit organizations, a part of that loss, the loss incurred on externally restricted endowment funds, did not pass through the income statement. That loss amounted to $111.8-million, offset by the receipt of $39.9-million of endowed donations and grants.

- **Revenues and expenses**. Displaying a bar graph showing the growth of revenues and expenses from 1998 to 2003, Ms Brown noted that, overall, both revenues and expenses had been growing, with expenses growing more rapidly than revenues. Until 1999-2000, revenues had exceeded expenses, producing net income, but beginning in 2000-01, expenses had begun to exceed revenues. For 2002-03, the investment loss of $55.6-million had been a part of the reason for the net loss of $164.4-million, but there had clearly been other factors as well.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

Members observed that the $55.6-million investment loss had been recorded not as reduced revenue but rather as an expense. While that was no doubt proper according to GAAP, it did leave a misleading impression – that there was a much larger need to control expense growth than was indeed the case. The accounting treatment also exacerbated the comparison of expense growth at the rate of 9.9% over the past five years with revenue growth of only 4.7% over the same period. A significant proportion of the ostensible expense growth was in fact a revenue decline.

Ms Brown observed that the comparison of expense and revenue growth did not include a further amount of $111.8-million, being the investment loss on the externally restricted endowed funds. That amount was not recorded at all on the income statement, but was reflected as a reduction in the value of investments as recorded on the balance sheet.

The Committee engaged in a substantial discussion about the appropriateness of revising the financial statements and the *Financial Highlights* to separate out the investment loss on funds other than the externally restricted endowment funds in order to make it clear that a part of the apparent increase in expense was not an expense in the commonly understood sense but rather a loss of revenue. The Chair was concerned that the accounting treatment and the statement in the *Financial Highlights* could be misleading to the average reader, and he thought that the mistaken perception of an unusually large increase in expense would not be in the best interests of the University.

Ms Brown noted that this approach had been adopted at the suggestion of the external auditors. A senior partner in the firm had encouraged the approach in order to achieve consistency in reporting across the university sector in Canada. Mr. Bowman confirmed that, while it was no doubt the preference to do it this way in the financial statements of not-for-profit corporations, Ernst &Young would have no objection in principle to recording investment losses as negative revenue, should the Committee so prefer.

Ms Brown said that changing the accounting treatment would require numerous adjustments to the financial statements and it would not be possible to make the change in time to allow presentation of the revised statements to the Business Board and Governing Council. It was suggested as one option that that the Committee recommend approval of the statements on the understanding that the classification of the investment loss would be changed, a change in presentation that would have no effect on the bottom line. A second suggestion was to send the statements forward without change, but with either an explanatory note being included in the financial highlights or with a clarification being provided in the presentation of the statements to the Business Board and included in the report of that Board. The Committee agreed that the latter approach would be preferable.

Mr. Chee said that, in the light of the discussion, he would for future years favour recording any investment losses as negative revenue. The outcome would be easier to

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

understand and would provide a better year-over-year comparison of the changes in both revenues and expenses.

- **Revenues and expenses associated with endowed funds**. In response to questions, Mr. Chee commented on one reason for the growth in expenses compared to revenue. A large amount of money had been donated to the endowed funds during the bull market period up to early 2000. In accepting those donations, the University had also accepted corresponding obligations to expend money for the purposes of the endowment – the salaries of holders of new endowed chairs, student bursaries and fellowships, etc. The University would normally be able to support those purposes from the investment earnings on the endowed funds. Over the past three, bear-market years, however, that had not been possible. When earnings on the endowed funds were not forthcoming, or when they proved insufficient, the University had to draw on its regular operating income to support the endowed Chairs, student awards, etc. The University's problem had been exacerbated by a timing issue. The largest level of donations had come at the peak of the equity markets, when benefactors were enjoying a wealth effect. The University had therefore had to invest that money at the peak of the bull market. Then, the University had been required to fulfill the obligations taken on along with the donations in the three years in which the equity markets plunged. Had the large influx of donations come earlier, the University would have been able to buy securities less expensively and to build up the capital value of the funds during the bull market years before early 2000.

  Mr. Chee noted that the endowment had been invested according to ideas developed in the 1980s and 1990s, when universities sought to maximize returns by a heavy bias toward equity rather than fixed-income investments. Endowments were viewed as very long-term funds that should seek the highest possible return over the long term, compared to pension funds, which should be invested with a greater emphasis on fixed income in order to be able to make regular payouts to pensioners. In fact, it had become clear that endowment funds required an even more secure income stream than did pension plans. Endowment funds had to make payouts to support endowed purposes each and every year. For pension funds, a significant proportion of the payouts – those for active members of the plan not yet drawing pensions – could be deferred for some years. Therefore, the endowment fund's previous asset mix of 80% equities and 20% bonds, compared to the pension fund mix of 60% and 40%, had not proven to be appropriate.

  A member asked whether there was a risk of an insurmountable gap arising between (a) the expense required for the support of endowed chairs, student aid, etc. and (b) the endowment earnings. Mr. Chee replied that the University had in place a Policy for the Preservation of Capital of Endowment Funds, requiring that the real (inflation-adjusted) value of the endowed funds be preserved. The University had until this year been able to maintain the usual level of payout from the endowment by using excess earnings from previous years - amounts in excess of those paid out plus those required to compensate

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

for inflation. For the 2002-03 year, however, those re-capitalized earnings had been exhausted, and it had proven necessary to reduce the payout from $9.36 per unit of the Long-Term Capital Appreciation Pool (the unitized pool of endowment funds used for investment purposes) to only $6.60 per unit. If the markets continued to decline, it would be necessary to reduce the payout even further. The University had however, made a commitment to support the purposes of the endowed funds, and it would – and would have to – do so from its other sources of operating income.

- **Current year's deficit**. Ms Brown said that the net loss – expenses in excess of revenues – of $164.4-million was not the same as the deficit. Various transfers of $129.2-million resulted in a deficit of $35.2-million for the year, increasing the cumulative deficit to $67.2-million.

  In response to a question, Ms Brown said that significant transfers were not within the University's discretion and certainly could not be used to smooth income. For example, the various budget units were permitted to carry forward unspent budget appropriations into the next year, and these divisional carry-forwards were regarded as reserves. Similarly, many divisions had some trust funds within their control, which they might build up or draw down. A very important transfer was the payout from the endowed funds. One area where discretion had been exercised was a decision to transfer to the endowment $5.3-million of donations that had not been designated by the benefactors as endowed funds.

  Mr. Chee observed that the focus in budget discussions was on the surplus or deficit in the operating fund, after transfers.

  In response to a member's question, Ms Brown said that as at the end of the fiscal year, divisional carry-forwards, including purchase-order commitments, amounted to $54.4-million. That amount included some negative carry-forwards, where divisions had incurred deficits. The existence of those reserves was the outcome of a policy that allowed divisions to carry forward 100% of unspent appropriations to the next year. In the absence of such a policy, divisions would no doubt fully spend their appropriations rather than lose them. These reserves provided the only element of flexibility for division heads. In many cases, money was built up in carry-forward accounts for specific, planned purposes, such as the accumulation of start-up research funds needed to attract a potential new faculty appointment.

- **Financial trends**. Ms Brown observed that government grants for operations had declined as a proportion of total revenues from 1998 to 2003 from 35% to 33%. Student fees had increased from 21% to 31% over the same period. Government grants for operations had also declined as a percent of total expenses from 39.5% to 29.9%. This fall-off had been largely the result of the Government of Ontario's failure to provide

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

funding increases to compensate for inflation. That situation should turn around in the coming year as the result of two Government decisions. The first was to provide full average funding for enrolment growth. Funding had previously been capped at a stated enrolment level. Second, the Government would provide money from a Quality Enhancement Fund to assist the universities in protecting quality with the enrolment increase connected with the double cohort of students graduating in 2003 from the old five-year and new four-year secondary-school programs. This funding was assured until 2007 and would be very important to the University.

Ms Brown also observed that spending on salaries and benefits had declined as a proportion of total expenses between 1998 and 2003 from 61% to 57%. Student aid had increased from 3% to 7% of total spending.

- **Grants and contracts for restricted purposes**. The largest element in the revenue for restricted purposes was research grants. The increase in this revenue from $126.3-million in 1998 to $280.2-million in 2003 reflected both an increase in federal government funding for its three research granting councils and the University of Toronto's increasing success in obtaining this peer-reviewed research funding. This success, however, had its costs. The research grants were in support of particular research projects, which required the University to assume responsibility for the overhead costs of those projects. The University was, therefore, very pleased that the recent Government of Canada budget had made provision for on-going transfers to universities to cover the indirect or overhead costs associated with federally funded research, beginning in 2003-04. A one-time grant for this purpose had been made and recorded as revenue in 2001-02. This transfer would be a continuing one beginning in 2003-04, which would cover costs that were already being incurred.

- **Donations**. The University had received total donations of $75.9-million in 2002-03 and total donations of $603.1-million for the period 1998 to 2003. This included only cash donations and donations in kind. It did not include pledges. This number differed somewhat from that provided in Campaign reports because the number in the financial statements was limited to donations made to the University, excluding the three federated universities (St. Michael's, Trinity and Victoria), which were separate corporations whose donations were recorded on their own financial statements. Campaign reports included the donations to the federated universities, which were Campaign participants. For 2002-03, $36.6 million was reported as revenue with the remaining $39.3-million – representing donations to various endowed funds – being recorded as direct additions to the endowment. The former amount was expendable. The latter amount was intended to generate perpetual support for such purposes as endowed chairs, endowed student awards, etc. Responding to a question, Ms Brown reported that in addition to the $75.9-million donated, the University had received pledges of $116.2-million for future donations.

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A member noted that, while the Campaign was clearly enjoying extraordinary success, the cash donations in 2003 were significantly less than those in all of the preceding five years. Ms Brown replied that the level of donations in any year was frequently the outcome of very large individual donations such as the donation from the McLaughlin Foundation in 2002. Taking into account pledges received in 2002-03, that year had also been a successful one. The administration was very pleased with the progress of the Campaign and confident that it would reach its $1-billion goal and do so ahead of schedule.

- **Investment income on endowments**. Ms Brown reminded members of the policy that required the preservation of the capital and the purchasing power of the endowed funds. In 1998 and in 2000, the investment earnings of the endowment had exceeded by considerable amounts ($139.1-million and $92.4-million) the allocation for spending made in those years, allowing the excess to be re-capitalized to cover the costs of inflation and to provide for real growth in the endowment funds. For the past three years, however, it had been necessary to draw down the previously re-invested earnings. The University would not draw down any amount greater than the earnings that had been previously re-invested. As a result, the allocation for spending had declined from $57.3-million at the end of 2002 to $43-million at the end of 2003. That reflected the reduction in the payout rate per unit from 5% of the four-year average unit value to 4.2% of the current market value in 2003 – a reduction from $9.36 per unit to $6.60 per unit. As a result, the academic divisions would have $17-million less than the previous year to meet the increased costs of endowed chairs, student aid, etc.

  A member observed that a $17-million decline in a $1-billion budget was not as bad as it had initially appeared. Ms Brown replied that the decline was a matter of considerable concern in many divisions that relied a great deal on endowment income to meet fixed and increasing costs. In some cases, those costs were contractual obligations – such as the salary of the incumbent of an endowed chair. In other cases, the division would be in need of funds to meet policy commitments such as the student aid guarantee – that no qualified student would be unable to enter or complete a program because of the absence of financial resources.

- **Salaries and benefits**. Ms Brown noted that salaries and benefits represented the largest element of the University's expenses at 56.7% of the total. Ms Brown said that the cost of salaries and benefits reported in the financial statements included both the cash paid out and an accrual for employee future benefits – both pension benefits and other benefits made available to pensioners such as supplemental health insurance. The cost of salaries and benefits (other than employee future benefits) had increased from $538-million in 1998 to $731-million in 2003, representing modest compensation increases and more substantial volume increases, arising from the engagement of additional faculty members to serve the University's growing enrolment. Salaries and benefits were taking up an

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increasing proportion of revenue, forming an important element in the University's revenue gap.

In response to a question, Ms Brown said that the negative cost of employee future benefits until and including 2000-01 was the outcome of recording accrued pension income. With the pension plan then in a large surplus position, it had been possible to record pension income which more than offset the unfunded liability for other employee future benefits.

- **Student aid and student fees**. The University's spending for scholarships, fellowships and bursaries had increased by 262% from 1998 to 2003. During the same period, the University's revenue from tuition fees had increased by only 79.8%. The University's ability to increase its revenue from tuition fees was limited by the Government of Ontario's requirement that increases for 35,000 students - those in Arts and Science and certain other programs - be limited to 2% per year, not compounded. In addition, 30% of the revenue from tuition fee increases had to be devoted to student aid. Consequently, the increase in revenue from tuition fees from the 35,000 students in those programs fell far short of covering the inflation in the cost of teaching them. Student aid was increasing at a far faster pace because of (a) the rule that 30% of revenue from tuition-fee increases be devoted to financial aid and (b) the large proportion of the endowment devoted to student aid funding. A good proportion of the amount donated to student aid endowments had been encouraged and matched by the Government of Ontario's Ontario Student Opportunity Trust Fund (O.S.O.T.F.) program.

  In response to a question, Ms Brown said that fee increases above 2% per year were permitted only for some programs such as Dentistry, Law, Management and Medicine. In those cases, the University undertook not to increase fees by more than 5% per year for students who were currently enrolled in their programs and who completed them in the usual time. Fee increases greater than 5% were assessed only in those deregulated programs and only to new students entering them.

- **Balance sheet**. The University's assets had been increasing steadily in the years between 1998 and 2002, but they had then declined in 2003. Liabilities had been increasing steadily. The increase had been the outcome of: (a) borrowing for capital projects, (b) an increase in deferred contributions (liabilities recorded upon receipt of such things as research grants, which were discharged as the research projects were completed); and (c) an increase in deferred capital contributions (liabilities recorded upon receipt of funds for capital purposes and amortized over the life of the related capital assets).

- **Capital**. The University's capital was classified in four categories. The first and largest category was the endowed funds. The second was committed capital. This included such items as departmental trust funds and carry-forward funds and money set aside to match

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

the University's liability under its supplemental retirement arrangement. The third category was equity in capital assets, which represented the value of capital assets less the borrowing for those assets and less the deferred capital contributions. The fourth category was unrestricted capital, which for this year was a negative figure of $67.2-million, representing the University's cumulative deficit.

The amount of committed capital was reduced by a liability of $98-million for employee future benefits. That number was growing. When new GAAP rules required the recording of a liability for employee future benefits other than pension benefits, the University decided to record its approximately $155-million liability prospectively over fifteen years. The $79.5-million of committed capital was therefore net of the $98-million liability for employee future benefits and also net of the $47.6-million negative investment income reserve – the amount of the investment loss that would eventually be reflected in the University's deficit.

Ms Brown stressed that the University's investment loss was fully reflected in the financial statements for the year. That loss had not been amortized (although it had been regarded as amortized for budgeting purposes). The full amount was not, however, currently reflected in the cumulative deficit. The amount would be moved from the negative investment income reserve in the committed funds to the cumulative deficit over four years.

In response to a question about employee future benefits, Ms Brown said that before the change in GAAP to require the recognition of a liability for employee future benefits other than pensions, the University accounted and paid for such benefits on a pay-as-you-go basis. In fact, the University continued to pay the cost of such benefits when incurred; there was no fund, comparable to the pension funds, for such retiree benefits as medical insurance.

Ms Brown observed that of the University's $1.264-billion of capital, $1.062-billion resided in the endowment.

The University's equity in capital assets consisted of its capital assets that had not been funded by contributions from others, less amortization and less the amount of borrowing for those assets. When funding for capital assets was provided by others, for example the grants to construct research facilities from the Canada Foundation for Innovation, the assets so acquired were not included in the equity in capital assets. They were accounted for as a deferred capital contributions.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

- **Endowments**. The University's endowment funds supported endowed chairs and professorships, student awards, academic programs and research programs. The largest proportion of the endowment, amounting to $427.3-million, supported student aid.

  In response to questions, Ms Brown said that $43-million had been transferred from the endowment to unrestricted capital (deficit) to cover spending needs and a further $30.7-million had been transferred to unrestricted capital (deficit) arising from the year's investment loss. Of the total amount, $33.9-million had been transferred from the externally restricted endowments. The source of that transfer had been previous years' investment earnings above and beyond the payout and the amount needed to compensate for inflation, which amount had been recapitalized at the end of those previous years.

- **Operating fund**. Much of the attention of the internal University community focused on the operating fund. For the operating fund alone, expenses had exceeded revenues by $76.8-million. But, $61.3-million had been transferred into the operating fund, primarily from committed capital, leaving a $15.5-million deficit on the year's operations. That compared to a budgeted deficit of $4.4-million.

In the course of discussion, members made suggestions concerning the wording of two notes. Another member commented on the extraordinary financial complexity of the University and its financial statements, and she expressed her admiration at the ability of Ms Brown and her colleagues to produce such complicated statements so quickly.

Mr. Bowman referred members to the independence letter attached to the audit results, confirming that the auditors were not aware of any relationships between the University and Ernst & Young that, in the latter's professional judgement, might reasonably be thought to bear on the firm's independence.

The Chair had proposed earlier in the meeting that the order of the agenda be varied to permit (a) the private meeting with the external auditors and (b) consideration of legal services and claims before the Committee was asked to vote on the financial statements. The Committee agreed. Following consideration of those other items, the question was put on the financial statements.

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

YOUR COMMITTEE RECOMMENDS

THAT the University of Toronto audited financial statements for the fiscal year ended April 30, 2003 be approved.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30, 2003 (Cont'd)

In the course of discussion, Mr. Chee noted that the budget process focused entirely on one segment of the University's finances – the operating fund. It was difficult in consolidated financial statements to isolate the outcomes in that one fund. A member observed that that was an unfortunate situation. While the Audit Committee's duty was to ensure the probity of the financial statements, readers were concerned to know "what was really going on." The Chair observed that the Committee was not in a good position to judge the financial results against the operating budget because it had no information about that budget. He proposed that members of the Committee who were not members of the Business Board be invited to attend, as observers, the meetings of the Board that considered the budget.

The Chair outlined how he proposed to present the financial statements to the Business Board and invited comments. He wished to ensure that the Committee was comfortable with the presentation. The Chair would:

- Outline the Committee' process for reviewing the financial statements over two meetings.
- Convey congratulations to those involved in producing the very complex statements in so short a time.
- Advise the Board that the year-end results, as reflected in the financial statements, had confirmed that, as reported by the administration, the University was facing significant financial challenges. Those challenges were reflected in the following facts: the net loss of $164.4 million, including the $55.6 million attributable to investment losses; the $236.3 million reduction in capital, including the $111.8 million investment loss on externally restricted endowments; the exhaustion, as a result of poor securities market performance, of the cushion of excess undistributed investment income in the endowed funds.
- Advise the Board that the pension plan, which at the end of 2001-02 had an $84 million surplus, had a deficit of $398.3 million by the end of 2002-03.
- While acknowledging the very successful fund-raising Campaign, point out that cash donations had declined in 2002-03 to their lowest level in the past five years.
- Observe that these sobering financial results provided the context within which the administration was challenged to make the decisions required to achieve the University's academic mission.

A member observed his primary concern was that the decline in the value of the endowment might, even with a substantial improvement in the securities markets, have the effect of preventing the University from supporting the purposes for which it had accepted donations to the endowment. Mr. Chee reassured the member that the University would provide funding to meet those commitments. If investment income were to prove insufficient, the University would find other sources of funding.

4. External Auditors: Private Meeting

THE COMMITTEE MOVED *IN CAMERA*.

The Committee held its annual private meeting with the external auditors.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair reported that the external auditors had expressed appreciation for the support from, and for the capabilities of, the administration, noting an increasingly strong focus on key issues. The auditors had indicated that, given the nature of the financial pressures on the University at this time, it might be desirable for Mr. Chee to play a more active role in the budget process. Going forward, the University administration might consider the preparation of interim financial reports. That might take the present form of financial forecasts but presented more frequently, or, better, it might take the form of interim financial statements prepared on the basis of GAAP. Other not-for-profit organizations were reporting in that manner, although the University of Toronto would be the first Canadian university to do so.

6. Legal Services and Claims

The Chair referred members to Ms Brown's memorandum of May 16 and its attachments and invited questions. A member recalled that the administration had indicated its intent to acquire in-house counsel and asked if that had occurred. Ms Brown confirmed that Mr. Steve Moate had been appointed as in-house counsel to advise on human resources matters and that the Provost and the Vice-President, Human Resources were in the process of recruiting junior counsel to assist Mr. Moate.

A member asked about the two actions noted in the summary of legal claims, each for $1 billion. Ms Brown said the University believed it had very good defences to the two claims.

5. External Auditors: Appointment for 2003-04

Ms Brown referred to her memorandum of June 5, 2003 which provided the background to the recommendation that Ernst & Young be reappointed as external auditors for 2003-04. She noted that this would the fifth year in which Mr. Bowman had been the partner responsible for the audit. The previous partner had been in place for about nine years. As required by the Purchasing Policy, audit services would be reviewed during the 2003-04 year and a recommendation coming out of that review would be presented to the Committee in one year's time, to be effective for 2004-05.

5. External Auditors: Appointment for 2003-04 (Cont'd)

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

YOUR COMMITTEE RECOMMENDS

(a) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto for the fiscal year ending April 30, 2004;

(b) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto pension funds for the fiscal year ending June 30, 2004; and

(c) THAT the members of the University of Toronto Innovations Foundation be requested to appoint Ernst & Young LLP as the external auditors of the Foundation for the fiscal year ending April 30th, 2004 at a remuneration to be fixed by the Directors of the Foundation.

7. Audit Committee: Review of Role and Responsibility

The Audit Committee had completed its first year under its revised terms of reference, and the Chair recalled the Committee's intention to review its role and responsibilities at the end of the year. As a result of accounting and business scandals in the United States, a new environment for audit committees had arisen and had been enshrined in the Sarbanes/Oxley legislation. This had the potential of increasing expectations concerning audit committees in Canada.

Members discussed a variety of viewpoints that were emerging in Canada and concluded that the Committee would be better served by conducting its self-examination early this fall when expectations in Canada were less fluid. Much of the current dialogue did not apply to not-for-profit corporations. In response to the Chair's question, Mr. Bowman said that he did not see any gaps in the work currently being undertaken by the University's Audit Committee. He agreed with the view of most Committee members that more information on the changed environment in Canada would be useful before this Committee reviewed its responsibilities.

It was agreed that this item would be deferred until the first meeting of 2003-04.

8. Report of the Administration

The administrative assessors stated that they knew of no other matters that should be drawn to the attention of the Committee at this time.

9. Date of the Next Meeting

The Chair reminded members that the first meeting of the Committee for 2003-04 was scheduled for Wednesday, October 29, 2003.

10. Other Business

The Chair informed members that the Chancellor had written a letter to him, expressing concern that there had been insufficient disclosure in the 2002 Annual Report of the University of Toronto Management Corporation in that there had been no report of overall-fund investment performance relative to a peer universe of Canadian investment funds. The Chair reviewed the elements of his proposed response. The letter would indicate that the Committee took the Chancellor's concerns very seriously and would expect a report on those concerns from Mr. Chee at its first meeting in the fall. It would also note that, because UTAM had its own Audit and Compliance Committee, the role of this Audit Committee vis-à-vis these concerns was limited to ensuring processes were in place for addressing the matters. It would also note that it was the understanding of this Committee that Mr. Chee was working toward measures that would address questions raised by the Chancellor, and that these measures would be formalized in due course, likely within the next several weeks. The Committee agreed with a response that would frame the responsibility of this Committee, that would indicate the Committee was taking the Chancellor's letter seriously and that would indicate follow-up reporting from Mr. Chee in the fall.

The Chair expressed sincere thanks to members of the Committee for their service. He congratulated Mr. Myhal on his appointment as Chair and thanked him for accepting the assignment. He also thanked members of the administration for their support to the Committee and to the Secretary for his strong and consistent support. He looked forward to working with everyone around the table again next year as a continuing member of the Committee.

On behalf of the Committee and the Governing Council, Mr. Charpentier thanked Mr. Weiss for his outstanding contributions both as Vice-Chair and, for five years, as Chair of the Committee, and presented him with a gift. Members showed their appreciation by their applause.

The meeting adjourned at 7:40 p.m.

Secretary	Chair

September 17, 2003

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