

UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 75 OF THE AUDIT COMMITTEE

November 24, 2004

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, November 24, 2004 at 4:15 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. David Oxtoby
Mr. Roger P. Parkinson
Professor Gordon Richardson
Mr. Mark Weisdorf

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:

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

Mr. Neil Dobbs
Mr. Andrew O. P. Drummond

Regrets:

Mr. Gerald A. Lokash
Mr. Joseph Mapa
Mr. Richard Nunn

Mr. Christopher Sparks
Mr. W. David Wilson

In Attendance:

Ms Diana Brouwer, Ernst & Young
Dr. Peter B. Munsche, Assistant Vice-President, Technology Transfer*
Mr. Pierre Piché, Associate Controller
Dr. Adi Treasurywala, President, University of Toronto Innovations Foundation*

* In attendance for item 2.

**ITEM 2 CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD.
THE OTHER ITEMS ARE REPORTED FOR INFORMATION.**

1. Report of the Previous Meeting

Report Number 74 (October 27, 2004), including the confidential, “closed session” report on the consideration of the University of Toronto Press annual report and financial statements, was approved.

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**2. University of Toronto Innovations Foundation: Financial Statements for the Year Ended April 30, 2004**

Dr. Treasurywala said that the Innovations Foundation had had a good year in 2003-04. While revenue was somewhat less than projected in the Foundation's strategic plan, and while it had declined somewhat from the previous year, the amounts were small and the previous year had been an exceptional one with revenue deriving from the sudden maturity of an opportunity. It had been a very good year with respect to the Foundation's staff and its work. Invention disclosures, which were the basis of future revenues, had consistently exceeded projections. Dr. Treasurywala was therefore very optimistic for the future. In response to the Chair's question, Dr. Treasurywala said that he had found no surprises in assuming the leadership of the Foundation; he had served for some time as Chief Operating Officer. There had been a minor issue with respect to the accounting for the sale of technology to Biox Corporation, requiring a restatement of the Foundation's balance sheet for 2003, which restatement had no effect on the bottom line. At the conclusion of the discussion, Dr. Treasurywala expressed his thanks to Ms Brown and her colleagues for their assistance in the preparation of the financial statements.

Dr. Munsche reported that the Board of the Foundation had met earlier in the day and had, on the recommendation of its Audit Committee, approved the audited financial statements.

A substantial discussion took place, which included the details of the change in the accounting arising from the sale of a technology to Biox Corporation. Among the more general matters that arose in discussion were the following.

(a) Review of the Foundation. In response to the Chair's question, Dr. Munsche said that the report on the review of the Foundation had been received, and the Vice-President, Research and Associate Provost would be discussing it with his colleagues in the University's executive group. Soon thereafter, the Vice-President would be very pleased to provide copies to members of the Audit Committee and to others in the University. The report did contain recommendations for significant policy changes, including changes to encourage a greater degree of partnership between the Foundation and the University's teaching hospitals.

In response to a question, Dr. Munsche said that the review of the Foundation had arisen not because of concerns about its operation but because of changes in the external environment, in particular the much increased interest of both the federal and provincial governments in the transfer of university-developed technology to commercial application. Governments, in providing additional support for university research, including the partial support of the indirect costs of research, wished to see links between that increased support and the public good. Given that interest, the President and the Vice-President, Research thought it important that the University ensure that it was doing all that it could to foster appropriate technology transfer. The invitation to the Honourable John Manley, the former Deputy Prime Minister, to chair the review committee was meant to convey the fact that the University was taking the matter of public expectations very seriously.

In response to further questions, Dr. Munsche said that none of the recommendations of the review would affect the valuation of the Foundation's investments on its balance sheet. One of

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**2. University of Toronto Innovations Foundation: Financial Statements for the Year Ended April 30, 2004 (Cont'd)**

the recommendations would, if implemented, change the University's policy on intellectual property.

(b) Record of Canadian universities with respect to technology transfer. In response to a question, Dr. Munsche said that Canadian universities had been very successful in developing intellectual property that could be licensed for commercial use. That the revenues earned by Canada universities were only about half of those by U.S. institutions was the outcome of the lack of capacity in Canada to use that intellectual property. There was far less early-stage venture capital investment in Canada than the U.S.

(c) Strategic Plan. The Chair noted that the Foundation's expenses currently exceeded its revenue by a wide margin, with the University funding the difference. Was Dr. Treasurywala comfortable that the Foundation would be able to generate greater revenue to cover its expenses? Dr. Treasurywala replied that the Foundation's strategic plan, as approved by the University, called for a period where spending would not be matched by revenues. It was projected that borrowing of about \$11-million on the Foundation's line of credit would be required before revenues were built up to the stage where they would cover expenses. Dr. Treasurywala was confident that the Foundation would be able to achieve its plan. In response to a member's question, Dr. Treasurywala said that his confidence in the Foundation's ability to achieve its plan was undiminished by the change in leadership.

(d) Foundation's equity investments. A member referred to the table of investments held by the Foundation as at year end. It appeared that, in at least some cases, the inventor received cash when intellectual property was licensed to a start-up corporation. Therefore they bore no risk with respect to the development of the invention. On the other hand, the Foundation received shares, and therefore bore all of the risk involved in the development of the inventions. Dr. Treasurywala and Dr. Munsche replied that the Foundation had the flexibility to make arrangements on a case-by-case basis, and it did wish to build up an equity portfolio. There were circumstances in which a faculty member or other scientist who developed a technology would have little interest in taking on equity in a venture company, and a deal offering that individual cash would have the effect of keeping the opportunity to develop the technology alive. When the Foundation deemed an intellectual property worthy of development and accepted equity in the venture company developing that intellectual property, it usually proved in the long run that the University and the Foundation were better off than they would have been by settling for only royalties. In response to a further question, Dr. Treasurywala said that when a venture succeeded, the Foundation was usually able to sell its equity for ten times its original value.

(e) Valuation of investments. In response to questions, Dr. Treasurywala said that investments in start-up companies were initially valued at the price per share of their most recent financing until an initial public offering, at which time the shares were recorded at price per share of that offering. A member referred to discussions of changes to Generally Accepted Accounting Principles that would in future require that all investments be recorded at their fair value.

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**2. University of Toronto Innovations Foundation: Financial Statements for the Year Ended April 30, 2004 (Cont'd)**

Ms Brouwer replied that three exposure drafts had been approved that did call for accounting for investments at fair value. The new rules would come into effect for fiscal years beginning on or after October 1, 2006. While the new rules would have an impact on the Foundation's financial statements, the implementation of the new rules would not begin for the Foundation for two years.

(f) Schedule of operating expenses. In response to questions Dr. Treasurywala said that the annual cost of the Foundation's salaries and benefits had increased from \$708,000 in 2002-03 to \$1.1-million in 2003-04 in part because of an on-going expansion of staff, in accordance with the Foundation's strategic plan, and in part because some previous staff work that had been completed on a consulting basis was now, more appropriately, being performed on a salaried basis. The decline in rent from \$149,000 per year to \$48,000 per year was the result of a move from prior premises on University Avenue. The Foundation had been locked into the premises by a lease and had to sub-let them. During 2002-03, the Foundation paid rent on both the old and new premises, although it recovered the cost of the old. In 2003-04, it paid rent only on its current location.

On the recommendation of the Vice-President, Research and Associate Provost,

YOUR COMMITTEE RECOMMENDS

THAT the audited financial statements of the University of Toronto Innovations Foundation for the year ended April 30, 2004, a copy of which is attached hereto as Appendix "A", be accepted.

3. Business Arising from the Report of the Previous Meeting

The Chair noted that item 7 of Report Number 74 contained a long discussion of matters being followed up. Arising from the discussion, two items had been included in the agenda package for members' information – the University of Toronto Asset Management Corporation's semi-annual report on investment performance to June 30, 2004, which had been presented to the Business Board in October 2004, and the report entitled "Performance Indicators for Governance," which had been presented to the Governing Council in September 2004.

4. Internal Audit Department: Semi-Annual Report for the Six Months Ended October 30, 2004

Mr. Britt presented the highlights of his semi-annual report.

- **University auditing activities.** The department had, as at October 31, completed nine reviews with twenty-two reviews in progress and six draft reports issued. Two

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4. Internal Audit Department: Semi-Annual Report for the Six Months Ended October 30, 2004 (Cont'd)

departmental audits had been completed, five were in draft form, and twelve were in progress. Continuous audits (which reviewed selected transactions for all budget units) had been completed for two quarters and were in progress for two other quarters. The Department had been asked to undertake three special audits. None concerned financial improprieties. Four follow-up reviews had been completed with a further follow-up review in progress. A substantial amount of the Department's time in the first two quarters of the 2003-04 fiscal year (approximately 500 hours) had been used, as planned, to assist the external auditors with the year-end audit of the University's financial statements, the enrolment audit, and Ministry-funded review of capital spending projects.

- **UTAM auditing.** The Department provided internal audit services to the University of Toronto Asset Management Corporation (UTAM) on a cost-recovery basis. That work was carried out by a dedicated 60% full-time-equivalent senior auditor. The audit work was planned and completed under Mr. Britt's supervision. The initial auditor for that assignment had not returned from maternity leave, and, following a temporary replacement, there had been a vacancy for four months, with no internal auditing at UTAM. A new senior auditor had since been engaged.
- **Other departmental activities.** The Department's new web site had been rolled out in April 2004. The site included an internal control self-assessment tool for the departments and divisions and would by the end of the year include the risk self-assessment survey. The internal-control self-assessment surveys were intended for administrative staff to become informed about internal control effectiveness, policies and procedures, and fraud awareness and prevention. The risk self-assessment surveys would be used to inform the preparation of the Annual Internal Audit Plan. A member reported that she had toured the site and had found it to be an excellent one; in particular the questions in the "Frequently Asked Questions (FAQ)" section were very good.

Mr. Britt also reported that Department management had made presentations to groups of business officers/administrative assistants and academic administrators about effective financial management, internal controls and fraud awareness and prevention.

- **Staffing.** Mr. Britt observed that staff retention had been an issue, with three staff members having left the Department to take up other positions in the University. While that had been of considerable benefit to the University as a whole, it presented a challenge for the Internal Audit Department. During the reporting period, the Department was 0.7 full-time-equivalent staff under complement. A new audit manager had been engaged and the recruitment of two other staff members was underway.
- **Findings: Administrative accountability reporting.** As part of departmental audits, the auditors had assessed compliance with the requirement for individuals with financial responsibility to complete the annual accountability reports for the 2003-04 fiscal year.

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**4. Internal Audit Department: Semi-Annual Report for the Six Months Ended October 30, 2004 (Cont'd)**

106 reports should have been completed in the departments reviewed, compared to 149 in those departments reviewed the previous year. Of those, 35, or 33%, were not completed (compared to 46, or 30.9%, the previous year). Of the reports not completed, 6 were not completed by faculty (compared to 32 the previous year) and 29 were not completed by administrative staff (compared to 14 the previous year). The greater concentration of administrative staff not completing the reports was a function of the fact that the audits in the reporting period had concentrated on large, central administrative divisions. Again, the primary reason stated for the failure to complete the reports arose from the individuals' not understanding that the completion of a report was required.

- **Findings: residual risks.** Mr. Britt noted that the Internal Audit Department used a risk-based audit approach to evaluate critical business processes and internal-control systems within the unit. The approach used risk-identification and assessment tools and procedures based on the Business Risk Model Definitions. Mr. Britt drew members' attention to the definitions, provided in Appendix 2 to his report. The audits had identified some residual risks arising from the inconsistent application of control activities as well as non-compliance with policies and procedures. Those risks included:
 - Compliance risk – ineligible expenditures charged to grants;
 - Cash-flow risk – lack of effective cash handling, deposit and reconciliation procedures associated with such matters as the sale of goods and services and fee income;
 - Employee-integrity risk – arising from a lack of segregation of incompatible duties concerning cash handling, procurement and payroll transactions;
 - Procurement risk – caused by the failure to obtain competitive quotations or formal tenders in accordance with Purchasing Policy; and
 - Taxation risk – caused by processing payments to individuals through Accounts Payable rather than the payroll system.

However, the relative infrequency of those risks led Mr. Britt to conclude that the financial environment at the University was a very decent one. There were no critical internal-control or compliance deficiencies or other deficiencies that required immediate attention by senior management. The audit findings and recommendations dealt primarily with the need to improve the consistency of compliance with policies, procedures and laws and of control activities at the divisional level. The heads of the audited units had in all cases either already implemented or agreed to implement the recommendations included in the audit reports.

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**4. Internal Audit Department: Semi-Annual Report for the Six Months Ended October 30, 2004 (Cont'd)**

Among the matters that arose in discussion were the following.

(a) Accountability reports. A member observed that the number of accountability reports that were not completed appeared to be high and clearly represented an increase from the previous year. Was the University slipping back in this program? Mr. Britt replied that it was not possible to make valid comparisons from year to year because of the difference in the units that had been audited. For this year, the administrative staff who had not completed reports were staff who had some financial responsibilities, but who were not managers. They had been under the impression that only managers were required to complete the reports. In the previous year, most of the faculty members who had not completed reports were appointed to a teaching hospital, and it had not occurred to them to complete University accountability reports. However, because they held research grants administered by the University, they should have done so. Therefore, in both years the large number of people who had not completed reports reflected certain groups but probably did not reflect the completion of the reports across the University.

In response to a question, Ms Brown said that the University did not maintain a central inventory of positions for which reporting was required. Rather, the process was a cascading one. Staff at lower levels with some financial responsibility were expected to complete the reports and pass them up to their supervisors. The supervisors' reports attested that they had received all appropriate reports. When the head of the budget unit, for example a Principal or a Dean or a Director of a non-academic unit, signed their reports, they should have received reports from all appropriate staff in their units. If budget-unit heads signed off on their own accountability reports without having received all required reports from those who reported to them, they would, in effect, be taking on personal responsibility for any failures of those who had not reported. Ms Brown added that the central administration did not have an inventory of positions that should be submitting a report; the Controller did not know, for example, whether a chair's administrative assistant had or did not have any financial responsibility. The heads of the budget units were, however, well aware of their responsibility with respect to the reports. Ms Brown and Mr. Britt met annually with the heads of the academic units and addressed the annual training program for new academic administrators. As part of their participation, they provided information about the accountability reporting process and provided copies of the report forms, which were designed for particular kinds of positions, for example, vice-presidents, principals and deans, business officers in the various units, and principal investigators (the leading faculty members who held research grants). The questions in the report were specific to the role. The reports to be completed by business officers contained several pages of questions about specific duties. The reports expected of departmental chairs were shorter, asking whether certain functions had been established and whether the chairs properly monitored the financial activities in their departments. Apart from unusual situations, most reports were in fact submitted to the unit heads. At the grass roots of the University, however, some staff members were apparently unaware of the program or of their need to submit reports pursuant to it. The most frequent cases of grass-roots staff members' failure to complete reports involved individuals who did not have

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decision-making responsibility for financial matters but who did have other responsibilities such as data entry.

In response to further questions, Ms Brown and Mr. Britt said that the heads of budget units knew that their completion of the reports would be audited, including a check that all responses from members of their units were received and questions answered appropriately. While some unit heads probably completed the reports fairly superficially as a matter of routine, most saw the reports as a valuable reminder and check-list of things they should be doing in managing their units. The most frequent negative response was from principal investigators who were not aware of the requirements of the conflict-of-interest policy. In units where that problem arose, department chairs were advised of the need for education concerning the matter. With respect to business officers, most of them completed the reports very conscientiously, replying in detail to questions and providing substantial explanations where they provided negative or “not applicable” responses. The University did not have data on the number of negative or “not applicable” responses.

(b) Special reviews. In response to a question, Mr. Britt said that the three special reviews undertaken had not been in units defined as high-risk. In two cases, external granting agencies had required audits as part of their usual processes. In a third case, the academic unit had asked that the Internal Audit Department assist it in dealing with certain complexities with respect to a particular account. There was no suspicion of wrong-doing in any of the three cases.

(c) Internal Audit’s business-risk definitions and the University’s Risk-Assessment Profile. In response to a question, Ms Brown said that the Internal Audit Department’s risk definitions were directed at the operations of individual units. The University’s Risk-Assessment Profile, presented to the Audit Committee each spring, considered the operations of the University as a whole. It did make use of the factors in the Internal Audit risk definitions, applying them at the University-wide level, and adding various more general risks such as government-funding risk and external environmental risk – risks that were not present in the Internal Audit definitions.

5. Administrative Accountability Reports: Annual Report on the Program, 2003-04

The Chair drew members’ attention to the annual report on the implementation of the program of administrative accountability reports, which had been the subject of considerable discussion in the previous item. That report included the report signed by President Birgeneau.

Ms Brown said that the preparation of the annual administrative accountability reports unfolded at each level. The process was begun by the distribution of the reports to the heads of budget units, who were responsible for informing members of their units of the program and for instructing the appropriate individuals to prepare reports. The program was included in the

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**5. Administrative Accountability Reports: Annual Report on the Program, 2003-04 (Cont'd)**

annual training program for new academic administrators, and reminders were provided to unit heads at one of their meetings later in the year. The Program was presented as an important tool, providing a checklist for administrators to use from the beginning of their service to ensure that their departments were functioning well. Mr. Britt added that he had, about one month previously, attended a meeting of Principals and Deans, at which the President and the Vice-President and Provost had both strongly emphasized the importance of complying with the requirements of the program. Mr. Britt had been very pleased to hear the importance assigned to the program at the highest level of the University.

Two matters arose in discussion.

(a) Signing authority. A member asked whether the reports included a question about signing contracts, for example for consulting services, that might put the University at risk. Ms Brown replied that the University had on October 15, 2004 implemented a new policy on the Approval and Execution of Contracts and other Documents, which delegated greater authority to Principals, Deans and Chairs. Individual members of the faculty did not have the authority to sign contracts on behalf of the University.

(b) Reporting process. In response to questions, Ms Brown said that the questions on the reports of the higher level officers focused on their assurance that various financial management and control processes were in place. Other reports focused on assurance that the steps in those processes had been carried out. The President received eight or nine reports from Vice-Presidents and other officers who reported to him. The Vice-President and Provost received 28 reports, most from principals and deans.

6. Capital Projects: Financial Report

Ms Brown said that a capital-projects report was presented regularly to the Business Board to provide context for that Board's consideration of proposals for capital projects. That report showed the total cost and total borrowing for all capital projects as well as the budgeted cost and source of funding for each project. The report now before the Audit Committee was essentially a companion report that added the projected actual cost-to-completion of each project and the projected variance from the approved cost. Because project costs could increase over time, the Vice-President, Business Affairs was authorized to approve cost increases of up to 10% of the total project cost to a maximum of \$2-million. Increases beyond that required the approval of the Business Board. With Business Board approval, the budgeted cost of a project, as stated on the report before the Committee, changed. Therefore, all of the variances reported were small. Ms Brown noted that, of course, the scope and the cost of a project might also decline, but that happened less frequently.

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Among the matters that arose in discussion were the following.

(a) Other reporting. A member noted that the regular reports to the Business Board contained a number of other elements, although they might not be germane to the Audit Committee. The reports to the Business Board included a list of other projects on the capital plan, which projects had not yet been approved (a “wish list”). In addition, it showed where the University stood in relation to the use of its borrowing capacity: the amount used and that remaining for other projects. That information did help provide a more complete view of the status of the University’s capital program. Ms Brown said that she had been asked to provide a report to the Audit Committee to deal with cost control. The report to the Business Board on borrowing included borrowing for other purposes.

(b) Borrowing. In response to questions, Ms Riggall and Ms Brown said that the Business Board had approved a Borrowing Strategy, which defined the target external borrowing capacity as 33% of average capital over the most recent five years (which capacity amounted to \$489-million) and defined the maximum external borrowing as 40% of capital (which capacity amounted to \$587-million). The Strategy could certainly be provided to the Audit Committee, as could a report on borrowing, if such a report was appropriate for the Committee. The Business Board had approved the Borrowing Strategy and it reviewed an annual report on the Long-Term Borrowing Pool – the fund that contained the proceeds of borrowing until required for use and that would be used as a sinking fund to accumulate the amounts required to repay the bullet debentures when they become due. A member said that it would be useful for the Audit Committee to have a report on borrowing to help it to understand the University’s overall financial context, and the Chair requested that reports on borrowing be provided, so long as they existed or could be generated without the investment of too much staff time.

In response to a question, Ms Brown said that specific external borrowing of \$565-million had been approved. In addition \$200-million could be borrowed internally from the Expendable Funds Investment Pool, in effect the University’s cash float. External borrowing to date consisted of three elements: (i) a \$160-million debenture issued in 2001; (ii) a \$200-million debenture issued in 2003; and (iii) a balance of approximately \$55-million of various individual borrowings (primarily bank loans) taken out before the debenture issues to finance such self-funding projects as student residences and parking garages. The University planned to issue a further \$150-million debenture in the future. Of the \$765-million of specifically approved borrowing, \$658-million had been allocated, leaving about \$107-million available to meet a very large number of academic priorities with a total cost well in excess of that amount.

(c) Cost controls. A member referred to the two large projects now under construction: the Donnelly Centre for Cellular and Biomolecular Research, for which 47% of the approved cost had been expended, and the Leslie L. Dan Pharmacy Building, for which 33% of the approved amount had been spent. Was the administration comfortable that the projects were on track and that there would be no surprises comparable to the cost increase for another large, recent project, the Bahen Centre for Information Technology? Ms Riggall replied that she was comfortable that

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the two projects would come in on budget. She noted that the Bahen Centre, owing to the wish to have it completed urgently, had been undertaken by the University using a project manager rather than a general contractor. As a result, the University had borne the full risk of cost increases. The Donnelly Centre and the Dan Building were being constructed by general contractors, who had contracted to deliver the full projects at a given price. The member asked about the possibility of scope changes. Ms Riggall replied that there had been a change to the scope of the Donnelly Centre, but such changes were tracked carefully and could not be undertaken without the approval of the Governing Council.

A member asked whether the report showed cases where the Vice-President, Business Affairs had approved cost increases within her authority, i.e. increases of less than 10% of the total project cost to a maximum of \$2-million. Ms Brown replied that the report did not show such approvals and therefore did not show whether projects were coming in on or over their original budget. Ms Riggall assured the Committee that, during her term as Interim Vice-President, she had approved only one increase, relating to the 89 Chestnut Street (former Colony Hotel) residence. There had been one other request for an increase of about \$500,000 in the cost of the planned new student residence at the University of Toronto at Mississauga. However, Ms Riggall had asked before considering the request that all efforts be made to reduce the cost of the project.

(d) Process for approval and oversight of capital expenditures. A member stressed the importance of a good process for governance approval and oversight of capital spending. It was essential that the process begin with good analysis of the cost of projects. Was there good analysis from the initiation of projects? Was the process for establishing business cases for projects audited? Ms Riggall replied that the process for the planning and the analysis of the cost of capital projects had been solid in recent years. Mr. Britt said that there was no auditing of the process for preparing business cases for projects or of the business cases themselves. There was, however, careful auditing of controls concerning construction contracts. A member, who also served on the Business Board, observed that the process had improved dramatically in recent years, with fewer requests for increased appropriations for projects and in smaller amounts. There had some years ago been dramatic cost increases for projects. The overall reports on the capital program, presented to every meeting of the Business Board, had been a recent and very welcome innovation. Ms Riggall noted that the University had been fortunate that its construction program had not in recent years faced delays, and therefore cost increases, owing to strikes. While fixed-price contracts provided considerable confidence to the University, the occurrence of strikes remained a risk, as did the recent substantial increases in the cost of concrete and steel. If necessary, the administration would re-submit projects for approval.

7. External Auditors' Engagement Letter, Audit Plan and Audit Fees

Ms Brouwer presented the external auditors' engagement letter, plan and fees. With respect to the audit plan, because the administration had advised that there had been no significant changes in the financial affairs of the University, the audit approach would be similar to that used in the previous year. The auditors would identify and test controls with respect to donations and with respect to payroll and other disbursements. For other balances, the auditors would use such

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procedures as confirmations and analytic reviews to obtain audit assurance. That would be particularly the case in the area of investments. The audit of investments would include confirmations and reconciliation of the reports of the portfolio managers and the trustee, in addition to substantive work to verify the valuation of private-market investments.

Ms Brouwer said that the principal areas of audit focus would be the following:

- appropriateness of recognition of government grant revenue;
- classification of cash receipts among revenue, deferred contributions and additions to the endowment;
- accounting for capital assets and associated capital contributions;
- accounting for investments – especially derivatives and other instruments to ensure the new accounting rules were being properly applied; and
- audit of the process which takes financial information from the business-information system and converts it into the accounting and presentation required under generally accepted accounting principles.

Ms Brouwer noted that the final two areas of focus would require a substantial amount of time.

Ms Brouwer said that the extent of evaluation of internal accounting controls and the extent of testing were determined by the auditors' definition of materiality. Materiality for not-for-profit entities was, according to the Canadian Institute of Chartered Accountants' *Handbook*, defined as a range between ½% and 2% of revenues/expenses. The auditors would regard an amount greater than \$15 million, which represented approximately 1% of the University's total revenues in fiscal 2003-04, as material. The final determination of items to be regarded as material would also be affected by whether an item was sensitive and whether it was of a routine nature.

Ms Brouwer said that the auditors would rely on Hewitt Associates LLC to provide the actuarial estimates required to account for employee future benefit costs. The auditors would, however, review the assumptions and compare them to generally accepted benchmarks.

Ms Brouwer reported on four new developments in accounting standards. First, new provisions would come into effect for the University's 2004-05 financial statements concerning accounting for hedging. The University currently had long-term floating-rate bank loans, arranged prior to the more recent debenture issues, on certain student residences and parking structures. It had entered into interest rate swaps to convert the floating-rate debt to fixed-rate debt. It used hedge accounting to report those hedging relationships. The new accounting guideline required that hedge accounting be used only if certain conditions were satisfied. The University (along with other entities) was required: (a) to identify the nature of the risk(s) being assumed to implement the hedging strategy; (b) to designate that hedge accounting was being

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applied to record the hedging relationship; (c) to have formal documentation of its risk-management objective and strategy, the hedging relationship, the method for assessing the effectiveness of the relationship, and the method for accounting for the relationship; and (d) to have reasonable assurance that the hedging relationship would be effective. The auditors had worked with the administration to ensure that the necessary documentation was in place, and they were satisfied that the current accounting practices were in compliance with the new guideline. The auditors had also worked with management on new wording of the notes to the financial statements. Another guideline covered the University's other derivative financial instruments, which were used for investment purposes. That Guideline required that the derivative financial instruments be recognized on the balance sheet and measured at fair value, with changes recognized in income for the year. Those that satisfied hedge accounting conditions, such as futures contracts to hedge against unfavourable currency changes affecting foreign investments, qualified for hedge accounting. Ms Brouwer did not expect that the new guidelines would require any change in the reporting on the University's financial statements.

The second new provision required disclosure of any contingent liability for guarantees. Ms Brouwer did not anticipate any change being required in the University's accounting.

The third new provision dealt with disclosures concerning the liability for employee future benefits. The new provision did not change the accounting for employee future benefits, but required increased disclosure. The auditors would work with the administration to ensure that the notes to the financial statements complied with the new requirements.

The final proposed change, contained in three exposure drafts, concerned reporting on financial instruments; if confirmed, the change would come into effect for the University's 2007-08 financial statements. The effect of the exposure drafts would be to require reporting financial instruments at fair market values. Because the University already did so, the proposed new requirements would not have a significant effect on the University.

Ms Brouwer drew members' attention to the auditors' engagement letter, dated November 1, 2004 and addressed to members of the Committee. It outlined the external auditors' responsibilities and the limits to them; detailed management's responsibilities and the representations that management would be required to provide; described fees and billings; and dealt with other matters. It also set out certain standard terms and conditions.

The proposed fee for the regular audit of the operating fund was \$113,000, which represented the previous year's fee with only an adjustment for inflation. The fee proposal also set out the fees for the enrolment audit required by the Ministry of Training, Colleges and Universities as well as certain other externally required audits of certain restricted and capital funds. It also set out the fees for certain special audits including the ancillary operations and the pension plans. Finally, Ernst & Young provided a disclosure of all assignments other than auditing and the fees billed for those assignments between October 1, 2001 and September 30, 2004. Apart from two special consulting assignments (on the risk-review process and on the

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**7. External Auditors' Engagement Letter, Audit Plan and Audit Fees (Cont'd)**

additional financial-statement note disclosure required for the second round of the Ontario Student Opportunity Trust Fund), all additional assignments concerned tax matters.

Discussion focused on Ernst & Young's consulting work for the University.

(a) Tax consulting. In response to questions, Ms Brown said that the tax consulting assignments were of two types. The first dealt with tax accounting matters, and payment was on a fee basis. The second dealt with applications for rebates of goods and services taxes (G.S.T.) paid. Such services were provided on a contingency-fee basis, with the fee payable only if the tax payment was recovered. The University was cautious in its efforts to recover G.S.T. payments. It did not seek rebates where there was a significant risk that they might be rolled back by the Canada Revenue Agency.

(b) Policy on the use of the external audit firm for consulting assignments. The Chair asked whether the University had a policy or guidelines on use of the external audit firm for non-audit services. Ms Brown replied that the University preferred not to use consultants and did so only when there was not sufficient expertise among University staff. When consultants were engaged, the University sought out the best ones available in order not only to obtain advice but also to develop in-house expertise. In the case of the goods and services tax, it was clear that the Ernst & Young's consultant was the leading expert. A member suggested that, given the importance of the external auditors' maintaining their independence of the University, it would be appropriate to have a brief, written policy on the use of the audit firm for other purposes. The Chair noted that such policies were in effect in other corporations, and could be used as a basis for considering a University policy. Such a policy could also be useful to the external auditors in determining whether it was appropriate for them to accept a consulting assignment. Ms Brouwer noted that Ernst and Young had a stringent internal policy to guide its decisions about accepting consulting assignments from audit clients, and the firm would not accept assignments if doing so endangered its independence as auditors.

On motion duly made and seconded, it was RESOLVED

THAT the Audit Committee accept the external auditors' engagement letter, audit plan and audit fees for the year ended April 30, 2005, as outlined in the report from Ernst & Young dated November 1, 2004.

8. External Auditors' Management Letter to Management Arising from the 2004 Audit

The Chair referred to the external auditors' letter of recommendations to management, provided as a matter of course in connection with the external audit. It represented a service performed by the external auditors to provide added value from the audit. It contained suggestions for improvements, noted during the audit. The administration's response to the suggestions was included, and many of the recommendations had been, or would be, adopted.

REPORT NUMBER 75 OF THE AUDIT COMMITTEE - November 24, 2004**8. External Auditors' Management Letter to Management Arising from the 2004 Audit (Cont'd)**

In response to questions, Ms Brouwer said that the judgements concerning the level of risk arising from the items were those of the auditors. None of the matters included in the management letter to management would have any material influence on the reliability of the information contained in the financial statements. Ms Brouwer noted that a number of these detailed matters were the subject of on-going observations. The auditors did not intend to repeat their comments on these matters annually unless there was some substantial change.

9. Report of the Administration**(a) Members' Indemnification and Liability Insurance Coverage**

Ms Brown recalled that the Chair had distributed a memorandum on the subject of the meeting of Ontario university audit committee chairs and members, held at the University of Waterloo on October 4, 2004. That memorandum contained a report concerning indemnification and liability insurance for directors and officers. Mr. Cameron Rose of Marsh Canada had suggested that there were a number of areas where standard insurance coverage might be insufficient including: environmental liability, breach of fiduciary duty (as in managing pension funds), punitive damages, and payment of legal defence costs. He had stated his view that universities should develop an enterprise risk management framework and review their insurance coverages to ensure that their staff and governors were protected. Ms Brown stated that members of the Governing Council and its boards and committees were indemnified by the University "from and against all costs, charges and expenses whatsoever (including amounts paid to settle an action or satisfy a judgement and fines and other monetary penalties) that such a person sustains or incurs in or about any civil, criminal or administrative action, suit or proceeding that is brought, commenced or prosecuted against him or her, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him or her, in or about the execution of the duties of his or her office, except such costs, charges or expenses as are occasioned by his or her own willful neglect or willful default [Governing Council By-Law Number 2, section 27A]." In addition, members were covered by the University's errors and omissions insurance, carried through the Canadian Universities Reciprocal Insurance Exchange (CURIE). The terms of that insurance were written in the difficult period of the 1980s, and the coverage was, according to Mr. Eric Fleming, the University's Director of Risk Management and Insurance, broader than generally available in the current insurance market.

The Chair thanked Ms Brown for her comforting report. He noted that Mr. Rose's comments were of a general nature and indicated areas where members' protection *might* be insufficient. He had not specifically reviewed the CURIE policy.

(b) Orientation Sessions for Members

The Chair reported that Ms Brown had kindly offered to arrange orientation sessions for the new members of the Committee and any others who would be interested. Ms Brown said that

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she would also be pleased to distribute the updated slides for the orientations sessions to any or all members and to answer questions arising from the slides. The Chair invited members to be in touch with Ms Brown if they wished to take up her offer.

10. Dates of Next Meetings

The Chair reminded members that the next regular meeting was scheduled for Tuesday, **May 17, 2005 at 4:00 p.m.** At that meeting, the Committee would:

- consider the notes to the financial statements, as well as any format changes;
- review the annual risk-assessment profile;
- review the annual report on insurance and risk-management related to insurance;
- review the Internal Audit annual report and Audit Plan, and hold the annual private meeting with the Internal Auditor;
- review the audited financial statements for the University of Toronto Asset Management Corporation; and
- receive an updated financial report on capital projects.

The Chair also asked members to hold **March 16, 2005 at 4:00 p.m.** free on their calendars as a reserve date, in the event that any business were to arise requiring the Committee's attention. Finally, the Chair reminded members of the change of the date for the June meeting to review the audited financial statements. It was now scheduled for **Wednesday, June 22 at 12:00 noon.**

The meeting adjourned at 5:50 p.m.

Secretary

Chair

May 17, 2005