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UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 77 OF THE AUDIT COMMITTEE

June 22, 2005

To the Business Board,
University of Toronto.

Your Committee reports that it met on Tuesday, June 22, 2005 at 12:00 noon 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. Richard Nunn
Mr. David Oxtoby
Mr. Roger P. Parkinson
Mr. Christopher Sparks
Mr. Mark Weisdorf

Ms Catherine J. Riggall,
Vice-President, Business Affairs**
Ms Sheila Brown, Chief Financial Officer**
Mr. Mark L. Britt, Director,
Internal Audit Department***

Secretariat:

Mr. Neil Dobbs**

Regrets:

Mr. Gerald A. Lokash
Mr. Joseph Mapa
Professor Gordon Richardson
Mr. W. David Wilson

In Attendance:

Ms Diana Brouwer, Ernst & Young*
Mr. Pierre Piché, Controller and Director of Financial Services**
Ms Martha Tory, Ernst & Young*

* Absented themselves for the Committee's consideration of item 3, External Auditors: Appointment for 2005 – 06, and item 11, Internal Auditors: Private Meeting.
** Absented themselves for the Committee's consideration of item 5, External Auditors: Private Meeting, and item 11 Internal Auditors: Private Meeting.
*** Absented himself for the Committee's consideration of item 5, External Auditors: Private Meeting.

1. Report of the Previous Meeting

Report Number 76 (May 17, 2005) was approved.

THE FOLLOWING ITEMS ARE RECOMMENDED TO THE BUSINESS BOARD FOR APPROVAL.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005

Ms Brown said that the financial statements had been completed very soon after the end of the fiscal year. That represented a significant achievement by staff in the Financial Services Department, the divisions and departments, the Internal Audit Department and the external auditors. The statements had been prepared so quickly only with very hard work and many overtime hours. Ms Brown formally thanked all concerned. The statements had been audited and the audit report was a clean one.

Mr. Piché presented the financial statements.

- **Included in the financial statements** were all operations under the jurisdiction of the Governing Council. That included the controlled, separately incorporated subsidiaries with their own boards: The University of Toronto Press, the Innovations Foundation, the University of Toronto Asset Management Corporation and the University of Toronto Schools. It did not include the federated universities and the research administered at the affiliated teaching hospitals.

- **Net assets**. The University's net assets, referred to in the previous year's financial statements as its capital, represented its assets minus its liabilities. There were four key components of net assets. The first was the endowments. They consisted of contributions to the endowments plus the reinvested earnings on those contributions, recorded each year at their fair market value. The endowment capital could not be spent, and the investment earnings could be spent only for the purposes specified by the donors to the endowment. The second element was the investment in capital assets, or the University's retained earnings in its capital assets. That amount was reduced over time to take into account the depreciation recorded for each of the assets. The third element of net income was the internally restricted retained earnings – funds set aside and committed to be spent in the future for particular purposes. Those funds included departmental trust funds, other monies that were unspent by departments at year-end and carried forward, and monies set aside for the Supplemental Retirement Arrangement. The internally restricted funds were detailed and described in note 12 to the financial statements. The fourth and final element in net assets was the unrestricted deficit. This amount represented negative retained earnings. It was also described as the surplus/deficit.

- **Significant accounting concepts: revenues and expenses**. Mr. Piché stressed that the revenue recorded in the financial statements was not the same as funds received, and expense was not the same as funds spent. When the University received unrestricted grants and donations, the amount was recorded as revenue when the money was received. However, when it received grants and donations that were restricted to particular purposes, the amount was recorded as revenue only when it was spent for its designated purpose. Until that time, any unspent restricted grants and any unspent (but expendable) donations were recorded as liabilities on the balance sheet: deferred contributions and

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

deferred capital contributions. When donations were made to the endowment funds, they were not recorded as revenue. Rather, they were added directly to the endowments on the balance sheet. Similarly, investment earnings on the those externally restricted donations made to the endowments were not recorded as revenue but rather as direct additions to the endowments on the balance sheet.

Expenses included non-cash items, including the depreciation of capital assets and the recording of a liability for employee future benefits earned in a given year, in accordance with the accounting rules.

- **Significant accounting concepts: internal fund accounting**. Internally, the University recorded its financial transactions using fund accounting. There were four funds. First, the restricted funds consisted of donations, including endowments, and research grants. Second, the capital fund included all capital projects except those for the ancillary operations. Grants and contributions for capital purposes were recorded in the capital fund, and depreciation of capital assets recorded there, again with the exception of the ancillary operations. The financial transactions of the ancillary operations were recorded in a separate fund. Those operations included the residences, food and beverage services, parking, Hart House, the Real Estate Division, the University of Toronto Press and the University of Toronto Innovations Foundation. The remainder of transactions were recorded in the operating fund, which included the teaching and administrative activities of the University, supported mainly by government operating grants, student fees and sales of supplies and services.

- **Interdependency of financial components**. Mr. Piché stressed that the various components of the financial statements were interdependent. For example, growth in the University's enrolment would generate more revenue from government grants and tuition fees. But that would in turn require an increase in the faculty to teach the increased student population, meaning increased expenses and the need to raise additional funds from advancement activities. It would also require the addition of facilities, meaning increased capital spending and assets and, in the absence of full funding for new facilities, increased fundraising, borrowing and liabilities. An increase in research activity would have similarly complex effects. An increase in donations would bring about an increase in revenue, but donations were usually made to support specific purposes, which would require a corresponding increase in expenses. Some donations were made to the endowments, bringing about an increase in net assets but also an increase in investment income and in expenses in future years.

- **Financial results: assets, liabilities and net assets**. Assets were $3.3-billion. Deferred contributions were $0.8-billion. Liabilities were $0.8-billion. Net assets were therefore $1.6-billion.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

The components of the net assets were: the endowments valued at $1,422.8-million (comprising 87% of net assets), internally restricted funds of $91.7-million, investment in capital assets of $266.4-million. Those three components were reduced by the unrestricted deficit of $144.8-million.

Net assets had increased by $149.1-million, including an increase in the value of the endowments and the investment in capital assets.

The endowment had grown from $1,287.7-million as at April 30, 2004 to $1,422.8-million as at April 30, 2005. That increase was the outcome of positive investment returns and the generosity of the University's benefactors. The increase of $135.1-million arose mainly from the following: donations to the endowment of $34.9-million, grants to the endowment of $37.8-million, investment income on the externally restricted endowment of $35.2-million, and investment income on the internally restricted endowment of $9.2-million.

The investment in capital assets had grown from $187.9-million as at April 30, 2004 to $266.4-million as at April 30, 2005, that notwithstanding a year's depreciation. That 42% increase had taken place because of the University's funding more capital assets with internal funds than with external borrowing. The outcome included both an increase in the unrestricted deficit to reflect the internal borrowing and also an increase in the investment in capital assets.

- **Financial results: revenue and expenses**. Revenue for the year was $1.65-billion, a substantial increase from the 2003-04 revenue of $1.57-billion. The increased revenue reflected the growth in enrolment and in the level of research activity. Expenses for the year were $1.61-billion, again a substantial increase from the previous year's $1.52-billion. The increase in expenses was the result of both inflation and the increased number of faculty and staff while driving the increased revenue: higher enrolment and more research activity. The outcome was net income of $41.2-million, the second year of net income in a row, which had followed three previous years of net losses.

  However, the year's result was also affected by the need to make internal transfers and commitments of $138.3-million. First, $78.5-million had been transferred for investment in capital assets. Second, the University had committed $32.6-million more than the previous year for specific purposes. Third, $27.2-million had been transferred to the endowment funds to match donations for such purposes as endowed chairs and student awards. As a result, the University had finished the year with a current-year deficit of $97.1-million.

2. **Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005** (Cont'd)

- **Revenues by category**. Of the year's revenue of $1,653.8-million, investments had provided $82.8-million. Expendable donations had provided $48.0-million. Revenue from other sales and services had provided $194.8-million, a substantial increase from the previous year's $170.2-million, reflecting the increase in the number of parking garages and residences in operation for the full year, as well as an increase in sales at the University of Toronto Press. Revenue from grants and contracts for restricted purposes had been $302.4-million. The decline from the previous year's $317.2-million reflected a difference in the timing of expenditure of that revenue (because revenue from restricted expendable purposes was recognized only when spent). Revenue from student fees was $472.3-million, a substantial increase from the previous year's $433.1-million, reflecting the increase in enrolment from 55,700 to 57,900 full-time-equivalent students. Finally, government grants had provided $553.5-million, an increase from the previous year's $484.3-million, again reflecting the increase in enrolment and research activity. That revenue also included a number of special grants.

- **Revenue: Government grants for general operations**. Government grants had funded 37.5% of general operating expenses in 1998-99. By 2003, that had declined to 31.1%. The proportion had increased to 31.8% in 2003-04. In 2004-05, the $553.5-million of government grants had funded 34.3% of operating expenses. The 2004-05 figure had included the special grant of $26-million for facilities renewal provided late in the year. In the absence of that special grant, government grants would have funded 32.7% of general operating expense. Other special grants for the year had included $17-million of undergraduate accessibility funding to assist the University in increasing enrolment to serve the double cohort, $5.6-million for graduate accessibility, and $9.7-million to compensate the University for the Government-imposed freeze on tuition fees.

- **Revenue: Government and other grants and contracts received for restricted purposes**. The University had received $34.3-million for capital infrastructure and other capital purposes; while that figure was much less than the $41.5-million received the previous year, it was in line with the average amount over the past six years. Research grants and contracts had been increasing substantially over the past six years. The University had received $346.9-million in 2004-05, compared with $319.3-million the previous year and significantly lesser amounts in earlier years. The increase in research funding had been the outcome of two factors: Canada's much stronger research agenda and the success of the University's scientists and scholars in winning a disproportionate share of research funding.

  Mr. Piché recalled that funding for restricted purposes was not recorded as revenue as received. Money from expendable grants and contracts for restricted purposes was recorded as revenue as spent for the stated purposes, and money for restricted capital grants was recorded as revenue as it was depreciated. Until those conditions were met,

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

the cash receipts were recorded as liabilities – deferred contributions or deferred capital contributions. In the University's accounts, $302.4-million was recorded as revenue in 2004-05, compared with $317.2-million in 2003-04.

- **Revenue: donations received**. The $82.9-million of donations received was an impressive amount for a year that was not included in a formal fundraising campaign. A total of $34.9-million had been donated to the University's endowments, up from $31.9-million the previous year. Expendable donations, reported as revenue on the University's accounts, amounted to $48.0-million, up from $39.4-million the previous year. Donation receipts for the period 1999-2005 totaled $666.6-million, not including pledges that had not yet been fulfilled and not including funds raised by and for the federated universities. Outstanding pledges at the end of the year amounted to $120-million.

- **Revenue: Investment earnings**. With good market conditions during the year, the return on the investments in the endowment was 7% for 2004-05. The University had earned $118.0-million on its investments. Of that amount $82.8-million was recorded as investment income, with the remaining $35.2-million of earnings on externally restricted endowments recorded as a direct addition to the endowment capital. The payout from the endowment was $49.4-million, with additional earnings of $35.2-million on the externally restricted endowments and $9.2-million on the internally restricted endowments. The University had earned $24.2-million on its expendable funds, with some of those funds having been invested in the same fund as the endowments (the Long-Term Capital Appreciation Pool). The 7% earnings of that fund had been offset by the reduction in short-term rates to less than 2%.

- **Expenses**. Expense for salaries and benefits had grown from $536.1-million in 1998-99 to $936.3-million six years later in 2004-05. That reflected a growing number of employees, growing salaries arising from negotiations with the various groups representing the University's employees, and a growing expense for pension, vacation and other benefits (see below). Non-salary expense had grown from $386.9-million in 1998-99 to $676.3-million in 2004-05. That reflected the growth in enrolment and in research activity. Over the past year, non-salary expenses had grown by $62.6-million. That growth had included the following increases in expense: materials and services costing $10-million; the cost of sales of $7-million reflecting increased sales by the ancillary operations; utilities costs of $6-million; repairs and maintenance of $10-million; conference expenses of $3-million and certain other expenses of $8-million, including the cost of book purchases for the libraries.

  In response to a member's question, Ms Brown said that the increase in salary expense had averaged about 4½% over the past six years, consisting of across-the-board increases of between 2% and 3% and progress-through-the-ranks increases for faculty and merit

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

increases for staff averaging about 1½%. The remainder of the increased expense had arisen from growth in the number of faculty and staff. There had been significant staff reductions over the 1990s, with the number of staff at the end of the decade fewer than at the beginning. After 2000, with the very large increase in enrolment, the number of staff had begun to increase again.

- **Expenses: Pension expense**. The University had made employer contributions of $68.7-million to the registered pension plans. Policy also required additional payments of no less than $26.4-million annually in order to address the deficit in the pension plan and the cost of the Supplemental Retirement Arrangement.

  For accounting purposes, however, pension expense for 2004-5 had been $69.2-million, a decline of $26.2-million from the previous year. Pension expense for accounting purposes was determined on the basis of the current service cost for pension benefits earned by employees during the year. Added to that was interest on the pension liability (at the increased discount rate) and subtracted from that was the interest earned on the assets in the pension funds. The outcome was further adjusted for the actuarial gains / losses during the year. The reduction in the pension expense was primarily the outcome of the lower actuarial losses booked for 2004-05 combined with the increase in the interest earned on the pension fund assets.

- **Expenses: Employee future benefits**. Accounting rules requiring the recording of the cost of employee future benefits had been one of the factors driving the increase in salary and benefits expense.

  The pension deficit as at April 30, 2005 stood at $369.5-million. Following a change in the accounting rules that had come into effect with the 2000-01 financial statements, the University was required to amortize that deficit over the average remaining service life of active plan members, and to date $102.3-million had been booked on the financial statements for that purpose.

  With the change in the accounting rules, the cost of employee future benefits other than pension benefits also had to be recorded as an expense in the year they were earned by employees, in a manner similar to pension benefits. (Those benefits were actually funded on a pay-as-you-go basis.) Those benefits included semi-private hospital care, extended health care and dental benefits. For current employees, the costs also included long-term disability insurance. Following the change in the accounting rules that had come into effect with the 2000-01 financial statements, the University was required, over fourteen years, to bring into its financial statements the accrued cost of those employee future benefits other than pensions. The deficit for those employee future benefits as at April 30, 2005 stood at $271.3-million. To date, $142.9-million had been booked on the financial statements towards amortizing that deficit.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

For 2004-05, the unfunded cost of dealing with those accounting rules had been $28.4-million, a reduction from $90.0-million in 2003-04 because of the increase in the amount of money contributed to the pension plan.

- **Capital investment in infrastructure**. Capital investment in infrastructure continued to grow, with construction required to support growth in enrolment and in research activity. New facilities and other capital additions included: the Leslie Dan Pharmacy Building ($36.3-million), the Terrence Donnelley Centre for Cellular and Biomolecular Research ($41.9-million), the Woodsworth College Residence ($32.2-million), the University of Toronto at Mississauga Parking garage ($12.4-million), the University of Toronto at Scarborough Arts / Classroom Building ($11.5-million), equipment ($47.1-million) and library books ($22.3-million). Total capital additions for the 2004-05 year amounted to $268.0-million, and they were anticipated at about the same level for 2005-06. The increase in capital investment in infrastructure had been accompanied by an increase in the University's debt.

- **External borrowing**. Total external borrowing as at April 30, 2005 was $410.6-million, a small decline from the 2004 figure of $415.1-million, as capital continued to be paid down on older bank loans and as two of those loans with high interest rates had been paid off. External debt as at April 30, 2005 represented 25.1% of the value of the University's net assets, down from 27.9% as at April 30, 2004 (reflecting the reduction in borrowing outstanding and the increase in net assets). External borrowing consisted of (a) a balance of $50.6-million on those bank loans, taken out to build residence buildings and parking garages, and (b) $360-million representing the principal value of two bullet debenture issues. The Governing Council had, in June 2004, approved the new Borrowing Strategy and a further $150-million of borrowing, but that borrowing had not yet taken place. It would likely be needed in the new fiscal year to provide partial financing for the continuing construction program.

- **Endowments**. The capital of endowments could not be spent. The only amount available for spending was the investment return earned after applying the Policy for the Preservation of Capital in Endowment Funds, the policy that was designed to maintain the value and the purchasing power of the endowed funds. Total endowments as at April 30, 2005 amounted to $1.423-billion, an increase of $135.1-million from April 30, 2004. The increase was the outcome of investment returns after the payout amounting to $44.4-million; $72.7-million of donations and grants to the endowments, and $18.0-million of transfers from expendable funds. The largest portion of the endowments was $599.7-million to fund student aid. That amount had increased sharply from $522.8-million at the end of the 2003-04 year. The largest additions to the student-aid endowment arose from grants from the Government of Ontario, announced in its May 2005 budget, for graduate fellowships and for funds to match donations to the

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

endowments under the Ontario Student Opportunity Trust Fund (O.S.O.T.F.) program. An amount of $434.8-million in endowed funds generated income to support chairs and professorships; $209.3-million generated income to support research programs; and $179.0-million generated income to support academic programs.

- **Investment income from endowments, the payout and the protection of the endowment capital**. Good investment returns in 2003-04 and 2004-05 had enabled the University to replenish monies that had been drawn down to fund payouts in the three earlier years of very poor capital-market returns. The monies that had been drawn down were taken from investment earnings that had been reinvested in still earlier years of good returns.

  In 2000-01, the value of the endowment capital had declined by $57.6-million after an allocation for spending of $49.6-million. In 2001-02, the value of the endowments had declined by a further $70.9-million following an allocation for spending of $57.3-million. Then in 2002-03, the value of the endowments had decline by a further $185.5-million after an allocation for spending of $43.0-million. The tide had turned in 2003-04, with $170.1-million reinvested after an allocation of $46.5-million for spending. In 2004-05, a further $44.4-million had been reinvested after an allocation for spending of $49.4-million.

  Mr. Piché displayed a graphical analysis of the payout and preservation of capital for the entire Long-Term Capital Appreciation Pool, the investment vehicle for almost all of the endowments (as well as the special designated fund built up for the Supplemental Retirement Arrangement). That graph showed the annual total return on the Pool, the income distribution from it, the cumulative amount reinvested to preserve the capital and the cumulative value of the Pool that would be required just to preserve its real value against erosion by inflation. As at April 30, 2003, a combination of negative investment returns from three years plus the effects of inflation had reduced the real (after-inflation) value of the Pool to something very close to the amount required to preserve the value of its capital after spending and after inflation. In April 30, 2003, the payout formula had been changed. The previous payout had been 4% of the average value of the units in the unitized Consolidated Investment Pool averaged over the past four years. That had been changed to a fixed amount of $6.60 per unit, that would be increased by 2% inflation thereafter. That new formula had resulted in a payout of $6.86 for 2005. That, along with two years of good investment returns and moderate inflation, had restored a positive cushion in the Pool in excess of the amount required to maintain the inflation-adjusted value of the units. While the value of the Pool as a whole had been restored and a cushion had been established, unfortunately, the value of some individual endowment

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

funds - those that had been established just before the sharp market decline - had not yet been restored. Some were still valued below the amount of the original cash contribution that had established the funds.

- **Statement of operations by fund: Operating fund**. Revenues in the operating fund for 2004-05 had been $1,143.6-million. Expenses had been $1,070.9-million, leaving a net income of $72.7-million before transfers. After transfers of $101.1-million out of the operating fund, the net loss was $27.4-million. The Operating Budget had projected a net loss of $24.3-million, meaning that the actual loss was very near to the target. The unrestricted deficit in the operating fund at the beginning of the year had been $10.5-million, and the $27.4-million loss had increased the cumulative operating deficit to $37.9-million as at April 30, 2005.

  Operating fund revenues had grown substantially over the past seven years, from $660.0-million in 1998-99 to $1,143.6-million in 2004-05. Similarly, expenses had grown substantially, from $618.4-million in 1998-99 to 1,070.9-million in 2004-05. The operating fund's net income of $72.7-million before transfers represented the second consecutive year of positive net income following net losses in 2001-02 and 2002-03.

  While there was a positive net income of $72.7-million, there were also transfers from the operating fund of $100.1-million. Those transfers represented operating funds that had been set aside for future spending as well as transfers to other funds. The transfers fell into three major categories. The first category involved setting aside $28.5-million for future spending, accounted for as transfers to internally restricted net assets. This included: (a) $10.6-million set aside from net income for the investment income reserve – the reserve that had been established to amortize over three years an unusual investment loss incurred in the Expendable Funds Investment Pool; (b) $23.7-million from net income that represented the increase in funds carried forward by the divisions, including unspent divisional appropriations at year end and unfilled purchase orders; and (c) $25.7-million set aside for deferred maintenance. Those transfers were offset by $27.6-million of the previously incurred cost of employee future benefits that was being taken into expense over fifteen years and that would not be recorded on the 2004-05 financial statements. The second category of transfers was the $49.7-million transferred from the operating fund to the capital fund for investment in capital assets: $14.3-million to cover that portion of the cost of capital projects during the year funded by operating funds, and $35.4-million to cover the cost of other capital assets such as depreciable equipment purchased with operating funding. The third and final category of transfer from the operating fund was the $21.9-milion transferred from net income to restricted funds, including $16.5-million transferred to the endowed funds to match donations made under certain special programs and $4.3-million transferred to the restricted fund for the Supplemental Retirement Arrangement.

2. **Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005** (Cont'd)

- **Statement of operations by fund: Ancillary operations fund**. In the ancillary operations fund, revenues had been $124.9-million and expenses $134.5-million, for a net loss of $9.6-million before transfers. The largest contributors to the loss were the 89 Chestnut Street Residence and the University of Toronto Innovations Foundation. An amount of $47.0-million had been transferred out of the operating fund, with $44-million of that having been invested in capital assets. The net loss after transfers had been $56.6-million. The unrestricted deficit in the ancillary operations fund at the beginning of the year had been $16.4-million, and the loss of $56.6-million had increased the cumulative deficit to $73.0-million as at April 30, 2005. However, an amount of $81.0-million was invested in capital assets recorded in the ancillary operations fund.

  In response to questions about the loss incurred by the 89 Chestnut Street Residence, Mr. Piché said that the business plan for this newly acquired residence called for it to break even in its operations on an annual basis after five years and to break even cumulatively after nine years. The operation currently broke even before the cost of debt service, and the availability of spaces at the residence had eliminated the University's very substantial previous expense to provide hotel accommodation for students, as required by its first-year residence guarantee.

- **Statement of operations by fund: Capital fund**. In the capital fund, the deficit was $13.1-million bringing the cumulative deficit to $33.9-million, representing internally funded capital projects. The spending on capital projects, of course, increased the value of the University's investment in capital assets.

- **Statement of operations by fund: Restricted funds**. In the restricted funds, revenues of $353.5-million had been matched by expenses of $330.6-million and transfers to other funds of $22.9-million to serve the stated, restricted purposes of the various funds.

- **Net assets by fund**. In the operating fund, net assets amounted to a negative $139.6-million. That included the internally restricted assets of negative $101.7-million. The largest negative element was the $222.9-million charge for employee future benefits, which was reported in the operating fund, from which the majority of employees were paid. The second element in the negative net assets was the unrestricted cumulative deficit of $37.9-million. Governing Council policy limited the cumulative deficit in the operating fund to $1.5% of operating revenues, which would amount to $16.2-million. That restriction, however, was applied only at the end of any long-range budget planning period, and it was projected that the deficit would be reduced to the 1.5% limit, as required, by 2009-10.

  Total net assets were $1.636-billion. The largest element of net assets was the endowment of $1.423-billion. Investment in capital assets amounted to $266.4-million, $185.0-million recorded in the capital fund and $81.4-million recorded in the ancillary

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

operations fund. Internally restricted net assets were $91.7-million, including $207.6-million set aside in a restricted fund for the Supplemental Retirement Arrangement, offset by the negative internally restricted net assets (as noted) in the operating fund and also in the capital fund. The unrestricted deficit across the operating, ancillary operations and capital funds was $144.8-million.

Net assets at the beginning of the year were $1,487.0-million, which had increased to $1,636.1-million at the end of the 2004-05 year. The $149.1-million increase in net assets was primarily the outcome of good investment returns as well as new donations and grants to the endowed funds.

Among the matters that arose in discussion were the following.

(a) The deficit. A member referred to the unrestricted deficit of $144.8-million at year end. He asked how the deficit was covered. Mr. Piché replied that the deficit was not a cash deficit. The largest component was a liability for employee future benefits, an accounting entry rather than a cash expense. Ms Tory observed that accounting in not-for-profit organizations required that the elements of net assets be separated, whereas in the private sector, the financial statements would record those components (apart from the endowments, which were unique to not-for-profits) in retained earnings. It was appropriate to compare the unrestricted deficit, a negative amount of $144.8-million, to the two positive amounts that could be thought of as comparable to elements of retained earnings: the internally restricted funds of $91.7-million and the investment in capital assets of $266.4-million.

The member said that, those explanations aside, the University budgeted for, and completed the year with, a deficit in its operating fund. How was that amount covered? Mr. Piché said that the University's cash flows were sufficient that it did not need to borrow to cover the operating deficit. For example, payments were received for research grants that were spent down only over time. Overall, the University's strategy was to make every effort to increase its revenues and reduce operating expenses.

Another member recalled that the six-year, long-range budget plan projected deficits in the middle years that were reduced by the end of the planning period. Would that plan be aided by the additional funding announced in the May budget of the Government of Ontario? Ms Riggall replied that the additional funding was very welcome, but the University's long-range budget plan had already anticipated much of it. The plan, approved in 2004, called for base budget reductions of 2% in 2004-05, 2% in 2005-06, 5% in 2006-07, 2% in 2007-08, 2% in 2008-09 and 3% in 2009-10. The additional funding in the Ontario budget would, at best, allow some reduction of the sharp 5% reduction planned for 2006-07. A very substantial reduction would still be required.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

(b) Government operating grants. A member noted that Government operating funding appeared to have been growing steadily over the past six years at an average compound rate of about 10% per year. Was that growth entirely in response to increased enrolment? Ms Riggall and Ms Brown responded that the growth was almost entirely in the form of special grants for such purposes as enrolment increases. Apart from such special amounts, Government funding had not increased.

(c) Overall assessment of the University's financial situation. A member asked whether the University would soon face a major structural problem in its financial situation. He observed, first, that while the University was increasing its enrolment and therefore its revenue, the revenue increases were insufficient to cover the cost of the increased enrolment, especially after taking into account the effect of inflation. Second, while the Government was providing some funding increases, those increases were tied to mandated purposes. Third, a substantial part of the University's future revenue streams would be required to service the debt undertaken for the capital projects required to expand enrolment. The member was concerned that the future would see needs for major budget reductions and substantially increased class sizes. While the University appeared to be managing its situation well to date, he was concerned that it was treading near the edge of a financial cliff. Another member expressed her concern that the University's financial situation would be subject to further pressure with the end of the double-cohort effect and the likelihood of enrolment reductions. She commented that the question of the University's overall financial position in the future was a very important one for the Committee. Another member said that if there was risk to the overall financial health to the University in the future, that risk should be disclosed in a note to the financial statements.

Ms Riggall replied that the administration shared the concern, and it formed the basis of the University's message to the Rae review of post-secondary education. The Government's response had been a positive one, with undertakings to provide increased funding to increase quality by enabling the University to hire more faculty, to reduce class size, to increase graduate-level enrolment to deal with the double-cohort and the demographic bulge that would soon reach the graduate level. The Government had, in fact, made it clear that the funding increase was to be used for those purposes and not used for faculty salary increases. With respect to capital debt, the Government did not have a separate source for funding new construction at this time. The University was not concerned about enrolment declines over the next few years. The University-age population would remain strong until 2010, and it was anticipated that the participation rate would increase.

Ms Brown added that the University's situation was strengthened, as observed by the credit-rating agencies, by the diversity of its funding sources. Of its $1.65-billion of revenue in 2004-05, only $553.5-million, or just over one third, came from Government operating grants. That gave the University some ability to adapt to stresses. In addition, cost-containment measures were in effect. Because government operating funding had not kept pace with inflation, the University's challenge on an on-going basis was to seek to increase its efficiency

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

(sometimes requiring increasing class size) and also to increase its revenue, for example by competing effectively for Canada Research Chairs and by raising funds for endowed chairs. The University had received full average funding for its additional enrolments. Taking on additional students required that the University take on marginal costs. It would be highly desirable that the additional funding be sufficient to meet more than the minimum marginal costs – that, for example, the University be able to provide teaching without increasing class size. But in terms of its overall financial situation, it had to work, and it would work, within the financial realities it faced.

A member observed that the real question was the University's ability to remain a going concern. Given the clear need for post-secondary education, any inadequacy of public funding would presumably be made up for by private sector funding. Ms Riggall agreed. She stressed that the University was a not-for-profit organization that was not mandated to produce surpluses.

(d) Transfers. A member observed that the University's net income had been transformed to a net loss after transfers, increasing the deficit. Did the University have any discretion concerning those transfers? Did it have the ability to control its deficit by controlling transfers? Ms Brown and Mr. Piché replied that, with one exception, all transfers were required by accounting rules or by the University's policies. For example, the transfer from the operating fund to the endowments to match donations was required to fulfill commitments to donors made under University policies. The transfer from the operating fund to the capital fund for the purchase of equipment was required because the University was obliged to record depreciation on that equipment in the operating fund. The sole transfer that had been discretionary was the $25.7-million restriction of funds for deferred maintenance. That had arisen from the receipt of funds just before the year end from the Government of Ontario, which funds had been applied to the cost of existing deferred maintenance projects. The University had set aside the same amount to cover the cost of deferred maintenance projects in the 2005-06 year.

(e) Note 4, Investments: derivative-related net payable. A member questioned the recording of the $17.9-million derivative-related net payable in the note providing the fair value of investments. He thought total value of the investments and the total amount of the liabilities shown on the balance sheet should have been increased appropriately in preference to providing the net amount with respect to derivatives. He was not sure that the current entry was consistent with Generally Accepted Accounting Principles (GAAP). Mr. Piché said that the net amount payable was recorded separately simply for simplicity. Ms Tory said that the treatment was currently acceptable under GAAP; changed rules would not become effective until October 2006.

(f) Note 4, Derivative financial instruments. A member suggested that the note should disclose information about the counterparties to the swap arrangements and that the Committee should examine the counterparty risk involved in the swaps.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

(g) Note 3, employee benefit plans. A member who was not able to attend had suggested that two questions concerning employee benefit plans be considered by the Committee. First, had the actuaries considered the financial implications of the end of compulsory retirement for faculty and the new, more flexible retirement arrangements? The member was surprised to find no reference in the footnotes dealing with this matter. Ms Brown said that the University had ended mandatory retirement for faculty as a policy change effective July 1, 2005. The actuaries had considered the implications. The policy change had arisen from a very specific agreement with the Faculty Association that had coupled the end of mandatory retirement with: (i) the end of the previous voluntary early academic retirement program (allowing for the possibility of retirements beginning at age 55), (ii) a new early retirement arrangement, and (iii) a new phased retirement arrangement. It was expected that the combination of the new arrangements would be cost-neutral to the pension plan. There would be no actuarial increase in faculty members' and librarians' pensions for service after age sixty-five; pensions would increase only as the result of the additional years of service.

The member had also asked about the increase in the pension deficit. He had been surprised to see an increase in the pension-plan deficit from $242-million to $370-million. In view of the good returns provided by the financial markets over the past two years, he would have expected to see a reduction rather than an increase. Mr. Piché recalled that it had been reported at the May meeting that the discount rate for the determination of the present value of the pension-plan liability had been reduced, as required to correspond with current long-term bond rates. That had brought about a substantial increase in the liability. While the value of the assets had increased, the amount of the liability had increased by a greater amount.

Ms Riggall and Ms Brown responded to a member's questions about post-employment benefit plans other than the pension plan. Those plans included the same contributory health-care plans as for active employees: semi-private hospital insurance, extended health-care benefits and dental care benefits. The extended health-care plan included the cost of prescribed drugs, with a $25 annual deductible and limits on the pharmacy fee that could be reimbursed. The extended health care plan also had limits on the use of certain services, for example psychological counselling and orthotics. Long-term disability insurance was available for only current employees and not for retirees. The various health-care plans were administered by Green Shield Canada, which issued cards and ensured that the plans were used only by the eligible plan members and not by others. In Canada, employers were not (as in the U.S.) allowed to reduce post-retirement benefits; the University's policy challenge would be to ensure no further increase in the cost of those already costly benefits. The current service cost of providing post-employment benefits was determined by the actuaries and recorded as an expense. The long-term disability benefit for current employees was funded by a $28.1-million fund. Apart from that program and the pension plan, other benefits were provided to employees and retirees on a pay-as-you-go basis. The costs for employee future benefits would continue to increase because of the continued amortization over fourteen years of the liability for those benefits in place at the time of the change in the accounting rules that had required the inclusion of that liability in the financial statements.

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

A member requested an explanation of the information about the University's pension plan as at April 30, 2005 as it appeared on the top of page 16 of the financial statements. Ms Tory explained that the accrued liability for pension benefits was $102.3-million. It was, however, necessary to add to that two other amounts. Those additions arose from the fact that certain major changes had taken place, which had not been brought into expense immediately. Because large fluctuations did take place from time to time, it was not necessary or appropriate to account for them all at once. Instead, the effects could be smoothed. The first change had been the discount rate, which had led to an unamortized net actuarial loss of $496.2-million. The second change had been a retroactive change in past service costs arising from (among other things) changes in actuarial assumptions, which had led to an unamortized past service cost currently amounting to $57.3-million. Adding those changes to the $102.3-million accrued liability, the outcome would have been a plan deficit of $655.8-million. However, the University was not required to bring the full effect of those changes into expense at once; rather they were amortized over fourteen years, the average remaining service life of active members of the plan. Therefore, an amount of $286.3-million, representing the transitional obligations that had not yet been amortized, could be removed from the deficit, leading to the plan deficit of $369.5-million. Ms Riggall said that the administration would consider revising the presentation of the information about the University's defined benefits plans in an effort to make it more readily comprehensible.

A member asked how the University planned to deal with the deficit in its pension plan and other employee future benefits. Ms Brown replied that, in addition to current-service-cost contributions, the University would expend an additional $26.4-million per year to eliminate the deficit in its pension plans, to ensure that there were adequate monies set aside in the restricted fund for the Supplemental Retirement Arrangement, and to build up a suitable reserve. With respect to other post-retirement benefits, the University would have to arrive at a plan. That plan could, but would not necessarily, involve establishing a restricted fund to deal with the costs. It would be possible to considered a registered plan, perhaps using future savings from pension contributions when the pension plans came out of their deficit positions and when a suitable reserve was in place. However, the amount required would be very large and would mean taking money desperately needed for teaching. The alternative was to continue the current practice of paying the costs of the premiums for these benefit plans for current employees and retirees on a year-by-year basis. In any event, the cost of employee future benefits had to be accounted for as a liability as those benefits were earned; they could not be accounted for on a cash basis.

A member observed that a significant increase in long-term interest rates might well have a negative effect on the investment returns generated by the pension fund, but it would also lead to an increase in the discount rate, and the latter effect was almost always the greater, leading to a favourable outcome with respect to the pension plan deficit.

(h) Foreign currency exposure. In response to a member's question, Ms Brown said that the operating fund's exposure to fluctuations in currency values arose from two factors. The first was the purchase of library books from abroad. The budget did contain a contingency item to

2. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2005 (Cont'd)

deal with any problems with such purchases arising from a possible decline in the value of the Canadian dollar. Second, the Long-Term Capital Appreciation Pool and the pension fund included substantial foreign investments, and the foreign currency exposure arising from those investments was actively managed by a firm engaged and overseen by the University of Toronto Asset Management Corporation. The foreign currency forward contracts, reported in note 4 to the financial statements, on page 19, were used in the management of currency risk arising from foreign investments.

(i) Interest-rate swaps. The interest-rate swap contracts reported in note 4 on page 19 referred to swaps on old, relatively small, variable-rate loans taken out to build certain residence buildings and parking garages. The effect of the swaps was to give the University a predictable, fixed rate of interest on the loans.

(j) Supplemental schedule 5, Comparison of actual operating fund results with original budget. A member suggested that the schedule be described by the common term "variance analysis." Ms Brown replied that the schedule went beyond a variance analysis. The operating budget was cash-based, whereas the financial statements included accounting entries such as amortization. The schedule reconciled not only the outcomes of budget lines but the entire budget with the financial statements. She noted that the Business Board did receive a variance analysis at least annually with text explaining the differences and the reasons for them. The Chair expressed his pleasure that the operating fund variance before changes in internally restricted funds and transfers was a positive one. He noted favourably the $29.7-million positive variance in divisional income from student fees.

Following the Committee's *in camera* meeting with the external auditors (see item 5 below), and its review of the report on legal services and outstanding claims (which formed a part of the basis for note 19, Contingencies - see item 6 below), the Committee considered a motion to recommend the audited financial statements for approval.

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, 2005 be approved.

3. External Auditors: Appointment for 2005 – 06

Ms Brown said that the administration had been pleased with the work of Ernst & Young. There had been a rotation in the partner in charge of the University's audit arising from the retirement of Mr. Keith Bowman. Mr. Bowman had retired a few months earlier than anticipated

3. External Auditors: Appointment for 2005 – 06 (Cont'd)

in order to avoid any possible conflict of interest arising from his daughter's new appointment to a client firm. Mr. Bowman had been in his sixth year as the partner in charge of the University's audit, and a partner rotation would therefore have taken place in the near future in any event. Ms Martha Tory was highly expert in accounting matters with respect to the not-for-profit sector and with respect to universities in particular, and she was very familiar with the University of Toronto. There had therefore been no discontinuity or gap in service. Mr. Piché added that Ms Brouwer, the audit manager, had been very proactive, and had worked diligently to resolve all matters arising in the course of the audit, facilitating the expeditious preparation of the audited financial statements so soon after the end of the fiscal year. Mr. Britt concurred; Ms Brouwer had been very effective in coordinating the work of the external and internal auditors.

A member asked whether the University had called for tenders for audit services. Ms Brown replied that it had not done so. The University's Purchasing Policy required a review of professional services approximately every five years. That review had been conducted one year ago. The review had concluded that audit services were good and were being provided at a competitive price. The Committee received each fall information about the cost of all services provided by the external audit firm, which information included a survey of the audit fees paid by all Ontario universities. That information provided a good sense of value for money. In the light of the outcome of the review, it had been decided not to put out a call for tenders for audit services.

With respect to the independence of the external auditors, Ms Brown said that they were required to sign an independence letter. While Canadian corporations were not bound by the U.S. Sarbanes Oxley legislation, the University of Toronto was attentive to it. The U.S. National Association of College and University Business Officers (NACUBO) had determined how that legislation should be applied to U.S. universities. Its recommendation was a change in audit partner every seven years. A change in the audit firm was not appropriate in the university sector, where specialized knowledge was very important and available in a limited number of firms.

In response to a member's comment, Ms Brown said that the administration had a few years ago negotiated a fee reduction with Ernst & Young, which the firm had been able to provide by ceasing to present to the Committee a detailed document describing the audit plan. Over time, the Committee had requested such a document, and Ernst & Young had provided it without an increase in the fee. A member stressed that it was important not to seek so low a fee that the auditors would be unable to provide good services.

On the recommendation of the Chief Financial Officer,

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, 2006;

3. External Auditors: Appointment for 2005 – 06 Cont'd)

(b) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto pension plans for the fiscal year ending June 30, 2006; 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, 2006 at a remuneration to be fixed by the Directors of the Foundation.

THE FOLLOWING ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

4. Business Arising from the Report of the Previous Meeting

The Chair recalled that there were three items for follow-up from previous meetings, as follows. Ms Riggall and her colleagues would respond at a later meeting. A member raised a fourth item.

(a) Report Number 75, November 24, 2004, item 7 - External Auditors' Engagement Letter, Audit Plan and Audit Fees

The Chair recalled that at the November meeting, the administration had been asked to consider the advisability of developing a policy on the use of the external auditors for assignments other than the financial statement audits. He noted that such policies were now mandatory in the corporate world.

(b) Report Number 76, May 17, 2005, item 3 - University of Toronto Asset Management Corporation, Financial Statements, 2004

The Chair recalled that Ms Riggall had at the previous meeting undertaken to provide advice on the question of the Committee's consideration of the financial statements of the University of Toronto Asset Management Corporation. The question had arisen whether to release those December 31 financial statements publicly before the Committee's review of them at its May meeting. Ms Riggall noted that she had initiated a discussion of the matter with the Secretary of the Governing Council.

(c) Report Number 76, May 17, 2005, item 8 - Capital Projects: Financial Report

The Chair recalled that Ms Brown had taken under advisement the suggestion that the semi-annual report on capital projects contain certain additional information, such as a comparison of the originally approved cost of projects to their final cost.

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

(d) Report Number 76, May 17, 2005, item 7 - Risk Management and Insurance: Annual Report, 2004

A member asked whether there had been any developments with respect to the Canadian Universities Reciprocal Insurance Exchange (CURIE). Ms Brown replied that the CURIE Board had at its May 2005 meeting received the report on the review of CURIE operations. The report and its recommendations had been released to CURIE subscribers. It recommended changes to CURIE's structure, governance, and services. It would be considered at CURIE's annual general meeting in September, and Ms Brown would report further to the Committee in the fall. In response to the member's question, Ms Brown said that the review report did recognize the seriousness of the concerns of the University of Toronto and others. While this University did not necessarily agree with all of the recommendations, especially those concerning services, the report provided good recommendations which would represent changes in the right direction.

5. External Auditors: Private Meeting

The Chair recalled that the Committee met at least annually with the external auditors, with no members of the administration, the Secretariat, or the Internal Audit Department present. During that meeting, the external auditors were invited, as provided in the Committee's terms of reference, (a) to advise "whether adequate cooperation has been received from [the] administration and whether [the] administration has exerted any undue pressure," (b) to comment candidly on the probity and the competence of the University's senior financial officers and its Internal Audit Department; and (c) to respond to members' questions.

THE COMMITTEE MOVED *IN CAMERA*.

The Committee met privately with the external auditors.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair stated that it was agreed that there were no matters arising from this meeting that would require action. The external auditors had expressed their gratitude for the co-operation received from the administration, and they had complimented them on their ability to produce the financial statements for the Committee's consideration so soon after the end of the fiscal year.

6. Legal Services and Claims

The Chair recalled that the Committee's terms of reference charged it to review "in connection with the review of the audited financial statements, an annual report on the use of legal services and on substantial outstanding legal actions against the University in order to monitor possible risk exposures and contingent liabilities."

6. Legal Services and Claims (Cont'd)

Ms Brown said that the report included information on: (a) the budgeted and actual use of legal services by the University's central administrative divisions in 2004-05 compared to the two previous years; (b) information on the payments made to various legal firms and the value of legal work performed by in-house lawyers; (c) a summary of the major legal work and costs for the year; and (d) a summary of legal claims outstanding against the University amounting to $300,000 or more. The objective of the final part of the report was to provide backup for note 19(b) to the financial statements dealing with contingencies, specifically litigation.

In response to questions, Ms Riggall, Ms Brown and Mr. Piché said that the spending on legal services by the Business Affairs portfolio, which was more than double the budgeted amount, dealt primarily with real estate (especially zoning matters) and construction matters. One significant cost was legal advice in connection with the redevelopment of the Varsity Stadium site. The University did not have a legal department. However, a number of in-house counsel performed specialized roles, reporting to different Vice-Presidents. Those roles included advice concerning: employment matters; relations with employee groups and unions; trusts and agreements with benefactors; intellectual property; and other research matters. Various legal actions launched by construction companies, amounting to $1.9-million and involving outstanding liens against University buildings, were largely claims by subcontractors against contractors, where the University was named as co-defendant. The amount of claims outstanding relating to construction was roughly the same as one year ago.

7. Internal Audit: Annual Report, 2004-05

Mr. Britt presented his annual report. He noted that he had provided a draft of his report to the University's executive group about one month earlier in order to obtain feedback. The Internal Audit Department had completed 26 draft and final reports as outlined in table 1 of the report. All had been identified in the audit plan presented to the Committee. The residual risks found in the audits were outlined in table 2 and were consistent with those identified in previous years. The source of risks was often the absence of adequate resources to enable the appropriate segregation of duties and monitoring. The number of instances of those risks had, however, been declining over the past five years, likely indicating an improvement in staff development programs and better awareness of policies and procedures. The recommendations arising from the audits focused on improvements in the application of current policies and procedures. Management of the various units had either taken action or indicated their intention to take action to comply.

Mr. Britt recalled that audits included a review of the completion of the annual administrative accountability reports. The rate of non-compliance found in audits completed in 2004-05 was 12.3%, a considerable improvement from previous years. He noted that a different sample of units was audited from year to year. The increased compliance might therefore be partly a function of the different units audited.

Mr. Britt reported on the other audit work completed by the Department. It had assisted Ernst & Young with its year-end audits of the financial statements as well as the enrolment audit

7. Internal Audit: Annual Report, 2004-05 (Cont'd)

and the audits of Ministry-funded capital projects. It had completed five special audits, undertaken at the request of management. The Department had completed its continuous auditing process – the quarterly review of selected transactions in all budget units. Finally, the Department had continued to supply internal auditing services to the University of Toronto Asset Management Corporation (UTAM), according to the terms of a service agreement. Among the subjects of reviews or follow-up reviews were: the performance-measurement process, the investment-reconciliation process, the compliance program and the asset-mix monitoring process. Revenue from this assignment enabled the Department to recover the cost of staff members working on the UTAM audits and also made a contribution to the Department's ability to purchase computers and software.

Mr. Britt reported that the Department had continued to see substantial staff turnover. The high level of attractiveness of internal audit staff to other University departments and the high level of demand in industry for internal auditors had made it difficult to retain staff and to recruit replacements. That situation presented the greatest challenge to the Department in seeking to complete its annual plans.

In response to a member's question, Mr. Britt said that his Department maintained a database on the various budget units. The first information was the response to a self-assessment survey, with responses fitting into weighted risk factors and leading to a risk score. The units were then stratified into various categories. A higher risk assessment could be the outcome of several factors including recent turnover in senior management, a large amount of money received from research grants, or an absence of segregation of duties among staff with key financial responsibilities. The Vice-Presidents responsible for the various budget units were advised of the risk ratings, but the units themselves were not so advised. Units selected for audits were notified two weeks in advance. The audits themselves were used to confirm or amend the risk ratings, previously based on the self-assessment questionnaire. Changes were frequently made, for example reductions for units with small budgets. Units classified as low risk were usually audited only through the continuous auditing process, although some such units were audited if issues arose, for example from the continuous audits or from requests for special audits in earlier years. The audit cycle for units classified as high risk was usually a maximum of four years.

8. Internal Audit: Audit Plan, 2005-06

Mr. Britt presented the Internal Audit plan for 2005-06. The plan was risk-based and in conformity with the standards of the Institute of Internal Auditors. In addition to departmental audits on all three campuses, the Department would: audit the University's information systems with particular reference to the information-technology governance processes; carry out its program of continuous auditing of selected types of transactions in all budget units; assist Ernst & Young with its audit work; complete follow-up reviews; and set aside time to undertake special reviews on request or as otherwise required. Selection of departments for audit had been based on the Internal Audit Department's risk data, bearing in mind its objectives with respect to

8. Internal Audit: Audit Plan, 2005-06 (Cont'd)

audit cycle frequency. In response to a question, Mr. Britt said that he had assigned a high priority to a follow-up review of the Capital Projects Department.

Mr. Britt noted that he hoped that the rate of staff turnover in his Department would be lower in the forthcoming year; that would be important to the Department's ability to achieve its plan. In response to questions, Mr. Britt said that the three of the four staff departures were for other positions in the University. Internal auditors were highly qualified, all with accounting designations and good University experience and training, and they usually developed good working relationships with the units they audited. They were therefore very attractive to departments seeking business officers. They did not have an alternative career path within the Internal Audit Department, with no position higher than Senior Auditor having come open in some time. A member noted that while this was problematic for the Internal Audit Department, it was a positive factor for the University as a whole. Another member suggested that Mr. Britt accept the likelihood of continued turnover and build in time for it in the Internal Audit plan. Mr. Britt noted that the Department had been fortunate that two former internal auditors who had not returned after maternity leave had been able to do some contract work; that had helped the Department to close off some files.

In response to another question, Mr. Britt said that the Department's internal audit services for the University of Toronto Asset Management Corporation did not exacerbate the Department's resource problem. UTAM provided funding for a 60% of full-time staff member, who was dedicated specifically to UTAM auditing. Mr. Britt also provided, and the Department was reimbursed for, 150 – 200 hours of his own time. The UTAM Audit and Compliance Committee appeared to be satisfied with that level of internal audit services for the scope of UTAM's operations at this time.

The Chair noted that the Committee would meet privately with Mr. Britt at the end of the meeting.

9. Borrowing Strategy: Status Report

Ms Brown said that the status report on the borrowing strategy was being presented to the Committee in response to a question at the previous meeting. The administration prepared an annual update on the borrowing strategy for the Business Board, which report was now before the Committee. Pursuant to the Borrowing Strategy approved by the Governing Council in June 2004, borrowing, primarily for capital projects, was of two kinds. The first was internal borrowing from $200-million of the University's cash float. The largest part of that float formed the Expendable Funds Investment Pool (EFIP). An amount of $200-million of EFIP was used to provide loans for a variety of capital projects. The sustainability of that use of EFIP would, of course, depend on the University's cash flows, but Ms Brown's assessment was that those cash flows for 2005-06 should be sufficient to continue to provide the external loans. The balance of the cash float had in fact been increasing. The fall-back, if required by changed cash-flow

9. Borrowing Strategy: Status Report (Cont'd)

patterns, would be external financing. To date, $89.6-million had been loaned under the internal financing program. There had been no defaults on those loans.

Ms Brown said that the second kind of borrowing was external. The University's Borrowing Strategy defined the maximum debt capacity as 40% of the value of the University's net assets averaged over five years. The target capacity was defined as one third of net assets, averaged over five years. The provision of averaging was intended to smooth out the effects of inevitable fluctuations in net assets from year to year. According to that definition, the maximum borrowing capacity as at April 30, 2005 was $593.9-million. Outstanding external debt as at April 30, 2005 was $410.6-million. The Governing Council, in June 2004, had approved external borrowing of a further $150-million, bringing total approved borrowing to $560.6-million. That additional borrowing would take place when required to finance capital projects and when market conditions appeared most conducive. There had been no approval to date to use the additional $33.3-million of borrowing capacity, as defined by the Borrowing Strategy. The external borrowing as at April 30, 2005 consisted of: various loans taken out to fund individual residence and parking buildings, with a balance of $52.4-million outstanding; a $160-million debenture issued in 2001 and due in 2031; and a $200-million debenture issued in 2003 and due in 2043. The debentures were bullet debentures, requiring semi-annual interest payments and repayment of the principal on the due date. The debentures were used to provide loans to individual units for capital projects. Those units signed loan agreements and paid blended principal and interest. The principal was placed in a sinking fund called the Long-Term Borrowing Pool, which would be used to accumulate and invest the principal repayments until required for repayment of the debentures. The income statement and the balance sheet for the Pool was included in the report. It would begin as a small pool of money and grow over time. The net assets of the pool as at April 30, 2005 amounted to $10.2-million, and Ms Brown said that the Pool was in reasonable shape at this early stage, four years after its establishment.

Discussion focused on the following topics.

(a) Target borrowing and maximum borrowing. A member observed that his understanding was that the University would borrow initially up to 33% of its net assets, with the maximum of 40% being available to deal with the possibility of an unpredictable reduction in the value of net assets arising from a problem such as a decline in the value of the University's investments. The stress in Ms Brown's report appeared to be on the maximum limit of 40% of net assets. Had there been a change of view? The member noted that there appeared to be a long list of important projects in the capital plan that could readily exhaust the University's borrowing capacity, even if defined as 40% of net assets. Ms Brown replied that borrowing could well reach the maximum 40% if the University proceeded with all of the highly ranked projects on its capital plan. The intention of the policy was that borrowing would normally be limited to 33% of net assets and the 40% maximum was to be reached only in the event of a decline in the value of the net assets. If indebtedness reached 40%, there could be no further borrowing until net assets increased. There had been a greater focus of the 40% limit more recently because of the need for new projects and the ability to service and repay that level of debt. The projects were

9. Borrowing Strategy: Status Report (Cont'd)

needed to enable the University to earn more revenue; leverage was an important factor in enabling an organization to grow.

(b) Use of the $150-million of borrowing approved in 2004. In response to a question, Ms Brown said that the University was proceeding slowly with respect to the further $150-million of borrowing approved in June 2004. She noted that about $90-million of the maximum borrowing capacity remained to be allocated.

(c) Long-Term Borrowing Pool. In response to questions, Ms Brown said that the net assets of the Long-Term Borrowing Pool, the sinking fund used to accumulate and invest money to repay the bullet debentures, were figured into the calculation of the University's net assets, as was the debt incurred for the projects financed by the debentures. In her view, there would be a sufficient balance in the Pool to repay the two debentures when they became due. The average duration of the internal loans that were repaying principal into the fund was 18¾ years. The terms ranged between 20 and 25 years, and were less for renovation projects. The first debenture would not fall due for 26 years and the second for 38 years. Under some circumstances, the Pool would generate more than enough to discharge the debentures. If there were some unanticipated change in circumstances, the University would have to refinance a part of the debt.

A member asked the extent to which the University's ability to repay the debentures depended on the investment returns earned by the Pool. Ms Brown said that the principal repayments from the internal loans would be sufficient to repay the debt. However, with blended principal and interest payments, the interest portion would decline over time, and the University would rely on the interest earned on the Pool to make its semi-annual interest payments to the debenture holders.

(c) Internal loans. The more recent internal loans, being repaid to the Long-Term Borrowing Pool, carried a rate of interest based on the then-current swap rate plus 100 basis points. The rate on earlier internal loans was the Canada one-year treasury bill rate plus 50 basis points. The spread was required to cover such costs as the costs of issuing the debentures and securing credit ratings.

(d) Determination of borrowing capacity. A member asked whether the University, in assessing its borrowing capacity, looked at factors other than the proportion of net assets. Did it, for example, consider cash-flow / interest coverage ratios? Ms Riggall and Ms Brown replied that the University itself had not used such measures, but the debt rating agencies did consider that and other tests, such as debt per student, to assess the reasonableness of the amount of the University's borrowing and the University's ability to service and repay its debt. The University used three credit-rating agencies.

(e) Ability to achieve the capital plan. A member noted that the University was drawing very near to the end of its borrowing capacity with many projects still on its list of priorities. Ms Riggall and Ms Brown agreed. They noted that the Ontario Budget had, however, promised

9. Borrowing Strategy: Status Report (Cont'd)

to make available $30-billion for University infrastructure over a number of years. It was unclear what this University's share would be and how the funding would be provided. One possibility was that the institutions would be required to borrow the necessary amounts, with the Province providing loan guarantees and payments to cover the cost principal and interest payments. A member asked how such an arrangement would affect the University's Borrowing Strategy.
Ms Riggall replied that it would require a revision of that Strategy. It would also require a reference to the debt rating agencies for their view of the effect of such an arrangement on the University's credit rating.

(f) General assessment. A member observed that the Borrowing Strategy appeared to be well thought out and conservative. The University could, if necessary because of unforeseen circumstances, roll a part of its debt when the debentures became due.

10. Report of the Administration

Ms Riggall reported on recent developments at the University of Toronto Innovations Foundation. The Business Board had on May 6, 2002 approved "the Innovations Foundation's request for a line of credit of $8.5-million, with terms similar to those outlined in the 1999 Line of Credit Agreement between the University of Toronto Innovations Foundation and the University of Toronto, provided that in the event that the draw on the line of credit in any year exceeds the estimate contained in the Line of Credit Agreement, the matter will be referred back to the Business Board for its consideration." The Foundation had reached the limit of its line of credit several months ahead of its business plan and it had become clear that it would not be able to pay down the line of credit at a rate of $2.5-million per year, as projected in its plan. The administration had therefore decided, and the Executive Committee of the Governing Council had approved, a reduction in the size of the Board, with the remaining directors consisting primarily of members of the University's administration, including Ms Riggall and Professor Goel in his role as Vice-President and Provost. It had become clear after twenty-five years of the Foundation's operation that the business model of a separate technology-transfer operation was not working out as planned. It was essential to continue the work of the Foundation in promoting the transfer of intellectual property developed in the University and protecting the interests of the University and its faculty in that property. Therefore, it was planned to merge the Foundation with the technology-transfer group in the Office of the Vice-President, Research and Associate Provost, and to make the combined unit a University unit funded by the operating budget. The licensing agreements and other arrangements developed by the Foundation would continue to generate revenue which would be used to pay down the line of credit extended to the Foundation.

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

(a) Experience at other universities. Ms Riggall said that experience with technology-transfer operations at other universities had been mixed, with some operations having achieved great success at generating revenues.

10. Report of the Administration (Cont'd)

(b) Future of technology-transfer operations at the University. Ms Riggall stressed that while it was important to encourage patenting of intellectual property in advance of publication, and while it was important to provide assistance to faculty who wished to commercialize their inventions, the University was not in the venture-capital business and should not itself be investing in those inventions. In response to a question, Ms Riggall said that the University would continue to assist faculty with protection of intellectual property and technology transfer, and she anticipated that the staff complement of 27 dedicated to that purpose would remain unchanged. The University would receive revenue from the intellectual property developed by its faculty through royalty income from licensing arrangements.

Another member observed that the University had not invested a great deal of money in ventures developing University-owned technology. Most of the funding had been devoted to assisting with patenting, writing business plans and arranging introductions to venture capital funds. It was important to take a long-term view with respect to early-stage venture capital, where success depended on a few "home runs." Presumably, the University would have to regard its spending in this area as an expense, with a hope that there would be some payback. Ms Riggall noted that the recent report of the University's Panel on Commercialization (the Manley Committee) had stressed the importance of steady-state funding for this activity.

(c) Governance role. A member recalled that the Business Board had delegated to the Committee responsibility for Governing Council oversight of the Innovations Foundation. It had for several consecutive years received annual reports from the Foundation with assurances that everything was proceeding according to plan. Ms Riggall replied that those assurances represented over-optimism. The University's administration itself had become aware of the extent of the problem only about two months ago. That developing awareness had followed the receipt of the Report of the Panel on Commercialization (the Manley Committee) and the resignation of the President of the Foundation.

Another member suggested that there was need for the Committee to be involved at an earlier stage and for it to examine financial controls with respect to the Innovations Foundation and similar operations. It would also be appropriate for the Committee to consider questions related to value for money. Ms Riggall noted that the Foundation's budget had been a small one of about $2.5-million per year, and a great deal of good work had been completed. The member thought that that amount was still a significant one in view of the University's overall financial situation, and it was not clear in her mind whether appropriate value had been received in return for the funding.

Another member stressed that 1999-2004 had been a bubble period for early-stage venture capital, when most investors could consider themselves lucky simply to have recovered their investments. It would nonetheless be important for governance to examine the matter. It should ask whether the correct management skills were in place for technology-transfer and whether the protection and development of intellectual property was being fostered in the appropriate way.

10. Report of the Administration (Cont'd)

It would be important for the Committee to be aware of these matters in advance of future developments.

The Chair pointed out that the Committee would receive the Foundation's 2004-05 annual report and financial statements at its first meeting in the fall. The operation was a small one relative to many university departments whose financial results were not monitored by the Committee. Nonetheless, the Committee was responsible for its Governing Council oversight, and it would be appropriate to examine the matter in the fall with the full facts placed before the Committee.

11. Internal Auditor: Private Meeting

The Chair recalled that the Committee met at least annually with the internal auditor, with no members of the administration, the Secretariat or the external auditors present. During that meeting, Mr. Britt was asked to state, pursuant to item 6 of the Committee's Terms of Reference,
"whether adequate cooperation has been received from management and whether management has exerted any undue pressure." Mr. Britt was also invited to bring to the attention of the Audit Committee any other matters he deemed appropriate.

THE COMMITTEE MOVED *IN CAMERA*.

The Committee met privately with the internal auditor.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The meeting adjourned at 3:50 p.m.

Secretary	Chair

October 26, 2005

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