UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 62 OF THE AUDIT COMMITTEE

November 7, 2001

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, November 7, 2001 at 5:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. Robert S. Weiss (In the Chair)
Mr. Donald A. Burwash
Ms Christine A. Capewell
Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. Richard Nunn
Mr. Roger P. Parkinson
Professor Wally Smieliauskas

Mr. Felix Chee, Vice-President - Business Affairs
Mr. Louis R. Charpentier, Secretary of the Governing Council
Mr. Mark L. Britt, Director, Internal Audit Department

Secretariat:

Mr. Neil Dobbs
Ms Beverley Stefureak

Regrets:

Ms Kwai Li

In Attendance:

Dr. George Adams, President and Chief Executive Officer, University of Toronto Innovations Foundation*
Mr. Curt Auwaerter, Vice-President - Finance, University of Toronto Press**
Ms Kathryn Bennett, Senior Vice-President - Administration and Human Resources, University of Toronto Press**
Mr. Keith B. Bowman, Ernst & Young
Ms Diana Brouwer, Ernst & Young
Ms Sheila Brown, Controller and Director of Financial Services
Mr. Graham Kemp, Director, Administrative Management Systems****
Ms Laurie M. Lawson, Managing Director, Asset Allocation and Special Asset Classes, University of Toronto Asset Management Corporation***
Mr. Donald W. Lindsey, President and Chief Executive Officer, University of Toronto Asset Management Corporation***
Mr. George Meadows, President and Publisher, University of Toronto Press**
Mr. Pierre Piché, Associate Controller
Ms Deborah E. Simon-Edwards, Executive Assistant to the Vice-President - Business Affairs
Mr. Allan H. Shapira, Hewitt Associates***

* In attendance for item 2.
** In attendance for item 3.
*** In attendance for item 4.
**** In attendance for item 7.

ITEMS 2, 3 AND 4 CONTAIN RECOMMENDATIONS TO THE BUSINESS BOARD FOR APPROVAL

REPORT NUMBER 62 OF THE AUDIT COMMITTEE - November 7, 2001

1. Report of the Previous Meeting

Report Number 61 (June 20, 2001) was approved.

2. University of Toronto Innovations Foundation: Annual Report and Financial Statements for the Year ended April 30, 2001

The Chair said that the Audit Committee's responsibility was not to conduct its usual review of the financial statements from the point of view of the adequacy of representation and disclosure. The statements had been reviewed and approved by the Foundation's own Board. The Committee's primary task was, at the request of the Business Board, to carry the lead responsibility for the Governing Council's - the controlling corporation's - stewardship with respect to the Foundation. Questions about the reliability of the statements would, however, be appropriate; the financial results of the Foundation were consolidated into the University's statements. Because the annual report and financial statements had been approved by the Foundation's own Board, the Audit Committee was asked to recommend that the Business Board "accept" rather than "approve" those documents.

Dr. Adams presented the annual report and financial statements.

- **Achievement of strategic plan**. Upon his arrival two years ago, the Foundation had formulated a strategic plan. On the basis of a line of credit provided by the University, the Foundation had set out to provide technology-transfer services to the University and to ensure that the benefit of the knowledge developed at the University was transferred to the economy. The Foundation was somewhat ahead of target in achieving its strategic plan. That plan had projected losses of about $250,000 per year in its operations over the first four years. Over the first two years combined, the total loss had been only $375,000.

- **Revenue** had grown significantly from $1.4-million in 1999-2000 to $3.5-million in 2000-01. A major event had contributed to the revenue growth for 2000-01 - the sale of a colon cancer screening technology to a licensee, Procyon Biopharma Inc. While the Foundation might well have preferred to maintain its interest in the technology, the inventors had retired from the University and there was need to marry the technology to another. The outcome had been a payment of almost $1.5-million in cash and shares to the inventors as well as shares valued at $782,000 divided between the University and the Foundation. While this capital gain did not assist the Foundation's cash flow, it had improved its overall financial position substantially.

- **New facilities**. The Foundation had moved into its new facilities on three floors of the office building at 243 College Street. The move had enabled the Foundation's Commercialization Managers to be located together with the University's research Business Development Officers, bringing about a great increase in efficiency. The necessary renovations were, however, costly, with the Foundation's costs amounting to some $300,000. Notwithstanding this cost, the Foundation had not fallen behind its cash-flow projection.

- **Community-Sponsored Small Business Investment Funds**. The Government of Ontario had passed legislation providing tax incentives (a 60% tax credit) for investment in small community-based venture investment funds. The venture-capital community had supplied money for three funds for investments in start-up businesses at the University and its affiliated institutions. The three funds were: (a) a $2.5-million fund for investments by Triax Capital Holdings in internet and software companies; (b) a $6-million fund for investments by Triax in biotechnology companies, and (c) a $5.5-million fund for investments by the venture capital arm of the TD Bank Financial Group in promising start-up companies in any field. The funds could provide seed money of up to $1-million in start-up companies, meaning that they could make $1-million investments in up to fourteen companies. There were, moreover, good prospects that further venture capital could become available under this program. The University's current Inventions Policy had ended the Foundation's monopoly on opportunities to develop inventions by the University's faculty, and the three funds provided an excellent incentive for faculty to bring their inventions to the Foundation. In addition, having money available in the funds would reduce the time required to bring the inventions to the market through start-up companies. The investors would be familiar at an early date with the new technologies being developed, would have confidence in the due-diligence work completed by the Foundation, and would therefore be in a position to complete their own due diligence much more quickly.

In response to a question, Dr. Adams said that the primary benefit sought by the Foundation and the University was the means to move inventions by University faculty into the economy more quickly. That would provide cost savings, because the cost of patenting mounted over time. The Foundation would also receive 10% of earnings on the investments after the return of the original capital to the investment fund.

- **Foundation role in the Toronto innovation community**. The Foundation was becoming a hub in the Toronto innovation community. It had, in partnership with various venture-capital firms and service providers, sponsored a business-plan competition. That competition had attracted forty entries, and the winning plan had attracted $1.25-million in capital for the start-up company. The Foundation had established a new incubator facility (Exceler@tor) for venture-capital-financed start-up companies, particularly those in the field of information technology. The facility consisted of 12,000 square feet at the Foundation's location at 243 College Street, which would be sufficient to provide space for some twenty start-up companies. The University of Toronto and five other southern Ontario universities would be available to provide expertise, various groups would be available to provide professional services, and the Foundation was lining-up venture capital groups to participate.

- **New strategic plan**. Having achieved a great deal of its original, five-year strategic plan, Dr. Adams and his colleagues were working on a new plan, aimed at positioning the Foundation as a key element in moving knowledge from the University of Toronto to the economy. The plan would envision the Foundation's leveraging the various relationships it had established to move intellectual property into the economy at a very high speed.

- **BIOX Inc**. In the course of discussion, Dr. Adams commented on BIOX Inc., the Foundation's second start-up business. BIOX had been formed to market an invention by Dr. David Boocock of the Department of Chemical Engineering and Applied Chemistry. That invention enabled the conversion of vegetable oil, including oil that had already been used for cooking, into biodiesel fuel and (unlike previous processes) to do so at room temperature and ordinary atmospheric pressure. The resulting fuel would contain no sulphur, greatly reducing the harmful emissions normally produced by burning diesel fuel. The process would enable the production of biodiesel fuel for about 30% of its selling price. A demonstration plant had been built to prove the efficacy of large-scale production using this process. It appeared that this company would enjoy great success. It was, however, never

2. University of Toronto Innovations Foundation: Annual Report and Financial Statements for the Year ended April 30, 2001 (Cont'd)

possible to be certain of success. There was always the risk of unforeseen problems, especially unforeseen competition from other new technologies.

- **Revenue generated for the University and inventors**. The Chair noted that the Foundation's income statement (statement of operations and net deficit) showed a loss (deficiency of revenues over expenses for the year) of $133,000. On the other hand, the expenses for the year included $1,642,000 for a capital gains distribution and $480,000 of royalty payments to the University and to inventors. Dr. Adams agreed that the overall financial outcome was a positive one to the University and its inventors.

- **Start-up companies**. In the course of discussion, Dr. Adams commented on the change in the Foundation's emphasis from generating royalties to encouraging start-up companies. The objective of promoting start-up companies was the anticipation that one or more would turn out to be "home run" companies that would generate very large amounts of money for the University. For example, Stanford University, the University of Wisconsin, and the Georgia Institute of Technology all enjoyed enormous revenue streams from very successful start-up companies. At the University of Toronto, the Inventions Policy gave the faculty member ownership of the invention, with the University retaining a 25% interest. That usually translated to between 10% and 12% of the start-up company's revenue. BIOX had the potential to be a "home run" company, and others including Neteka Inc. might well generate substantial revenue flows. While many inventions had enormous potential, experience had demonstrated that it was not possible to be sure in advance which would prove to be "home runs."

A full discussion took place. In the course of discussion, Dr. Adams responded to a number of detailed questions. Among the more general topics that arose in discussion were: (a) the major risks faced by the Foundation (failure of start-up companies and an imbalance between invention disclosures and the staff to handle them); (b) reputational risk (the Foundation had no experience of a technology that did more harm than good and would seek to avoid such an outcome); (c) the accounting treatment given to the proceeds of the sale of the colon-cancer screening technology to Procyon Biopharma (it was treated as revenue during the year but also described in note 3, "Investments" Dr. Adams undertook to take up the question of this accounting treatment with Ernst & Young); (d) the accounting treatment given to patent costs (expensed in the year incurred, with reimbursements recorded as revenue in the year received, rather than reimbursements being shown as a cost recovery, which would give a better picture of true revenue growth); (e) the effect of recent negative market conditions, especially for technology companies but for all venture-capital operations (unlike many new companies that had been based largely on successful promotion, University inventions represented real technologies; the Foundation's one internet start up, Neteka Inc., which provided software that allowed internet addresses in all world languages, had been cash-flow positive and was developing well); (f) substantially increased costs for salaries and benefits (it had been necessary and beneficial to upgrade the staffing of the foundation - a costly undertaking given the high level of expertise required); and (g) substantially increased costs for consulting fees (the Foundation was increasingly making use of consultants, often successful entrepreneurs themselves, to provide specialized expertise).

2. University of Toronto Innovations Foundation: Annual Report and Financial Statements for the Year ended April 30, 2001 (Cont'd)

On the recommendation of the Vice-President, Research and International Relations,

YOUR COMMITTEE RECOMMENDS

THAT the annual report and audited financial statements of the University of Toronto Innovations Foundation for the year ended April 30, 2001, a copy of which is attached hereto as Appendix "A", be accepted.

3. University of Toronto Press: Annual Report and Financial Statements, 2000-01

The Chair stated that the Audit Committee's responsibility with respect to the Press was exactly the same as that vis-à-vis the Innovations Foundation: to carry the lead responsibility for the Governing Council's - the controlling corporation's - stewardship. He noted that two members of the Audit Committee - Mr. Parkinson and himself - were directors of the University of Toronto Press. Mr. Parkinson was Chair of the Press Board. They would therefore refrain from voting on the motion to accept the annual report and financial statements.

Mr. Meadows presented the Press's Annual Report and Financial Statements. The Press had earned a net income for the year, albeit a small one of $12,000 and one that was under budget. It had, however, done so in a very difficult year for book publishers and retailers owing to well-known problems associated with a major national chain of book retailers and owing also to external economic factors. The distribution division had been adversely affected, but it had come through the year more successfully than all of its competitors. The printing division had not achieved its budget for the year, but it had remained profitable while twelve other printing companies in Canada had gone out of business. Its sales had increased although its net income had declined. The scholarly publishing division had been well under budget owing to a higher number of returns from retailers, including Chapters / Indigo. The retail division had finished the year ahead of budget, notwithstanding heavy discounting in the retail trade generally, a strike by part-time employees and the loss of the parking adjacent to the main St. George Campus store owing to construction of the Bahen Centre for Information Technology. The store at the Scarborough campus had moved from a portable to a more central location, and the new store had been very favourably received.

Mr. Meadows reported that the Press had celebrated its 100th anniversary during the year. The University Library had arranged at the Robarts Library a very successful exhibition of the history of the Press's publishing activities. The Press had hosted two receptions jointly with the Library: one in connection with the opening of the exhibition and a second in connection with the Toronto meeting of the continent-wide Association of Research Librarians. Another anniversary reception was held in conjunction with the Toronto meeting of the Association of American University Presses.

Mr. Meadows commented on the highlights of the financial statements.

- **Trade accounts receivable** had increased by $1.4-million and **accounts payable and accrued liabilities** had increased by $1.6-million. Those changes were largely the outcome

3. University of Toronto Press: Annual Report and Financial Statements, 2000-01 (Cont'd)

of reclassifying certain receivables and payables. Unsold books were returnable to publishers even after a number of years, and the number of returns had increased dramatically.

- **The net loan to the University** had declined by $635,000.

- **The audit** had been unqualified. The Press had been very conservative in its accounting.

Mr. Meadows responded to detailed questions, and a full discussion took place. Among the items of discussion were the following: (a) Contingent liability for returns of books to the scholarly publishing division (returns were well under the industry standard of 20% to 25% and the higher 40% industry average over the past year because of returns from Chapters / Indigo; the Press was not financially responsible for returns to the client publishers who used its distribution service; therefore no reserve was necessary); (b) Miscellaneous expenses (the $100,000 increase was largely attributable to the 100th anniversary celebrations; those expenses had been classified as miscellaneous rather than "travel and entertainment" to ensure good year-over-year comparability in the latter category); (c) Interest expense (the Press paid interest to the University on the amount of its outstanding loan above $3-million at the bank prime rate less 1%; in years in which it made a substantial income, it paid participating interest to the University on the amount of the loan under $3-million at an agreed rate, and it also contributed to a scholarly publishing trust fund; the first $3-million represented the University's investment in the Press and provided essential working capital); and (d) Strategic reviews of the Press that were underway (most university presses were subsidized; in this case, the Press earned subsidies for its scholarly publishing program through its other operations such as retailing, printing and distribution; it was therefore important to know the long-term prospects of those businesses).

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

YOUR COMMITTEE RECOMMENDS

THAT the annual report and audited financial statements of the University of Toronto Press for the year ended April 30, 2001, a copy of which is attached hereto as Appendix "B", be accepted.

The Chair congratulated Mr. Meadows and the staff of the Press on their outstanding work. It was a remarkable achievement that a university press, dedicated to publishing often-unprofitable scholarly books, would have been able to maintain profitable operations overall, earning a net income in ten out of eleven years since incorporation, including this past, especially difficult year. Mr. Parkinson reported that the Press had never been forced, for financial reasons, to decline to publish a scholarly book deemed worthy of publication by its Manuscript Review Committee. That represented an outstanding achievement.

4. Pension Plans: Annual Stewardship Report Including Audited Financial Statements for the Year ended June 30, 2001

The Chair said that the Committee's duty with respect to this stewardship report was to assure itself, the Business Board and the University community that the pension fund was in solid financial shape: properly funded, properly managed and properly accounted for. A report on all University investments, including the pension master trust investments, was made annually

4. Pension Plans: Annual Stewardship Report Including Audited Financial Statements for the Year ended June 30, 2001 (Cont'd)

to the Business Board in the spring, and that report was the key one with respect to the accountability of the University of Toronto Asset Management Corporation (UTAM) for investment performance. Nonetheless, questions dealing with the investment returns of the pension funds would be in order. The Committee would be asked to recommend that the Business Board approve the two sets of financial statements prior to their submission to the Financial Services Commission of Ontario.

Mr. Chee said that notwithstanding the very difficult equity markets, the pension plans and the surplus remained in good condition. The surplus of the University plan had declined from $391.9-million on July 1, 2000 to $337.7-million on July 1, 2001, which was still significant. The surplus in the plan for certain employees of the Ontario Institute for Studies in Education in the University of Toronto (OISE/U.T.) had declined from $31.4-million on July 1, 2000 to $29.8-million on July 1, 2001. As of July 1, 2001, the special fund being set aside to match the University's accrued liability for its Supplemental Retirement Arrangement was $34.6-million less than the accrued liability. Mr. Chee reported that the University was about to enter into salary and benefits negotiations with the Faculty Association; it was expected that pension issues would occupy a prominent place in those negotiations. Pension issues were receiving the administration's careful attention. Mr. Chee recalled that the 2000-01 year was the first one in which the assets of the pension fund had been managed by UTAM. The changeover, as of May 1, 2000, had resulted in new people and new approaches. Indeed, UTAM was continuing to introduce new asset classes. The returns of the pension master trust (which combined, for investment purposes, the two pension funds) should be viewed in the context of the change.

Mr. Lindsey said that UTAM had spent the entire year ensuring that the pension fund assets were properly diversified. As at January 1, 2001, the proportion of equities in the fund had been reduced from 65% to 60%, a change which had a favourable outcome to date. UTAM had also decided to allocate a portion of the fixed-income portion of the fund to long-term bonds. (The previous bond allocation had emulated the Canadian bond universe.) That decision had brought the duration of the assets into closer correspondence with the duration of the pension plans' liabilities, and it too had proven very useful in a period of declining equity markets. The diversification would continue going forward. If, for example, a single stock became dominant, as Nortel Networks had for a time become dominant in the Toronto Stock Exchange 300 Index, the diversification would ensure that the fund was not over-exposed to that stock.

Mr. Lindsey reported that the diversification had served the fund well except for the month of September 2001, which had been the most difficult month for the investment markets in recent decades - one in which virtually all asset classes had fared poorly. Fortunately, since that time, the markets had been recovering. Mr. Lindsey estimated that the pension fund would enjoy a 3% return for the month of October, and November had begun well. He stressed that as a matter of policy, UTAM did not attempt to time the markets. Such efforts rarely succeeded over the long run, and they frequently caused significant losses. For example, one pension fund in the United Kingdom had decided to move entirely to bonds at the end of September, losing the benefit of the rebound in the equity markets thereafter. UTAM would, on the contrary, rebalance back to the benchmark rate. UTAM had arranged the purchase of additional equities for the funds after the September decline, increasing the equity portion by 4% to restore equities to their benchmark weight. That had helped to recapture lost ground. Statistically, it was unlikely that the damage in the equity markets would continue in the light of the substantial decline for the

4. Pension Plans: Annual Stewardship Report Including Audited Financial Statements for the Year ended June 30, 2001 (Cont'd)

year to date, the current valuation levels, and the current low level of interest rates for fixed-income investments, which was positive for equity investments. The problem was the wild-card of political uncertainty. There was, unfortunately, no way of diversifying away all risk. Having said that, Mr. Lindsey believed that it was appropriate to continue diversification and to continue to avoid market timing.

A full discussion took place. Mr. Lindsey responded to a number of questions concerning the investment of the Pension Master Trust. Among the matters that arose were the following.

(a) Managing liquidity for pension payments. UTAM had been able to arrange for pension payments from the low-volatility, fixed-income portion of the pension fund, avoiding selling equities at a low point in the market cycle. UTAM was building a limited, specialized, in-house management capability that would enable the establishment of a liquidity pool - a pool of fixed-income securities to be used strictly for withdrawals. If necessary, that pool would be accompanied by an overlay of equity market index futures to provide for the appropriate equity exposure.

(b) Duration of the assets and liabilities. The average duration of the fixed-income securities in the pension fund was about 7½ years. The average duration of the plans' liabilities, based on the average age of plan members, was about 13 years. The addition of a long-term component to the bond portion of the benchmark had extended the average duration of the fixed-income assets, although the new duration had not matched that of the liabilities. It represented a compromise between matching the duration of the liabilities and limiting the volatility of the fixed-income component (longer-term bonds increased or decreased in value more than other bonds in response to changes in current interest rates).

(c) New trustee / custodian. UTAM was pleased with the work of the new trustee / custodian, State Street Canada. The custodian's systems permitted UTAM staff to view portfolio holdings and transactions on line in real time. In-house trading activity was fully automated, and UTAM's compliance manager was able to monitor activity in real time.

(d) Performance measurement. While the custodians also provided performance measurement services, UTAM was giving consideration to performing that function in-house in order to achieve a somewhat faster turnaround.

(e) Risk-management services. Available, external risk-management services included those provided by the custodian and by BARRA. While UTAM was giving active consideration to using such systems, Mr. Lindsey was not fully convinced of the value of traditional value-at-risk analysis.

(f) Steps to reduce volatility. The most important means to reduce the effects of market volatility was broad diversification, which UTAM had been using. It had recently added one new asset class - hedge funds that both purchased and sold stocks short in the same market sectors. UTAM was also considering investing in global fixed-income securities. The value of diversification had been declining in recent years, however, as international markets were becoming more correlated.

(g) Relative performance. The pension fund's performance relative to the median of a universe of other balanced funds was reported on the bottom of page 8 of the report. (For the four years ended June 30, 2001, the pension fund had earned an average annualized rate of return of 7.0% compared to the median fund's 8.0%. For the single year ended June 30, 2001, the pension fund

4. Pension Plans: Annual Stewardship Report Including Audited Financial Statements for the Year ended June 30, 2001 (Cont'd)

had lost 4.9% compared to the median fund's loss of 2.6%.) The universe used did not, however, provide an appropriate comparison because the current asset mix of the pension fund and the endowment fund were both much more diversified than those of almost all other funds in the comparative-measurement universe. The asset mix in the endowment fund was comparable to that of large U.S. universities, and UTAM used a universe provided by the consultants, Cambridge Associates. With respect to the pension fund, UTAM was working with Cambridge Associates and with the custodians to identify an appropriate comparative universe that would have a comparable asset mix. That universe would be used in UTAM's 2001 annual report. The pension fund's underperformance of the median fund was the outcome of its lower proportion of bonds than most pension funds and its lower proportion of Canadian equities, which had performed well relative to U.S. and international equities in the year ended June 30, 2001.

(h) Asset mix. UTAM remained confident that the asset mix in the Pension Master Trust Investment Policy, as recommended by UTAM and approved by the Business Board, remained appropriate for the long run. Mr. Lindsey noted that the securities markets had behaved atypically in the past year, and it was therefore difficult to stand by and do nothing. On the other hand, experience had proven repeatedly that the worst possible thing to do was to make frequent changes from an appropriate long-term asset mix in response to short-term developments.
Mr. Shapira said that over the long term, the plans' actuarial assumption of a real rate of return (return after inflation) of 4% per year and the fund's asset mix (60% stocks and 40% bonds) were consistent. A member suggested that UTAM measure the performance of its current benchmark retrospectively against that of the median fund of a comparative performance-measurement service. That would provide useful historical perspective with respect to the fund benchmark. Mr. Lindsey noted that the UTAM Board had requested a comparison of the performance of the fund's previous, more traditional benchmark against the new one. He thought that such a comparison, over a reasonably long period of time, would be appropriate. He would be pleased to share that information with the Committee. The Chair commented that such a comparison might well be useful given the significant recent changes in the management of the funds.

In the course of discussion, Mr. Chee, Mr. Shapira, Ms Brown and Mr. Piché responded to questions on other topics. Among them were the following.

(a) Developments since June 30. The Chair noted that since the actuarial valuation, the securities markets had deteriorated further. On July 1, the main pension plan's accrued liability was $1.770-billion. That had readily been covered by assets with an smoothed, actuarial value of $2.108-billion and a market value of $2.062-billion. What had been the effect of the market decline since the valuation? Mr. Shapira replied that he had been monitoring the matter carefully and projecting various outcomes. The plan remained in surplus on a wind-up basis and would do so in the absence of a significant further decline in the value of the assets. He stressed, however, that the actuarial valuation was, and any consideration of a pension plan should be, based on a long-term view.

(b) Effect of the valuation on the University's financial statements. Mr. Piché said that prior to the 2001 financial statements, the University had recorded a pension income. For the 2000-01 year, it had recorded a pension expense amounting to $2.8-million. Based on recent experience, the University's current forecast was for a pension expense of $17-million for 2001-02.

4. Pension Plans: Annual Stewardship Report Including Audited Financial Statements for the Year ended June 30, 2001 (Cont'd)

(c) Effect on the University's budget. Mr. Chee noted that the pension expense was an accrual rather than an actual expense. With the pension plan in an "excess surplus" situation, as defined by the Income Tax Act, employers were not permitted to make pension-plan contributions. If the surplus declined to less than 10% of the accrued liability or twice the year's current service cost, whichever was greater, the University would be permitted to resume employer pension-plan contributions to cover the plan's current service cost. A member noted that the University had very prudently maintained its base-budget provision for its current-service pension-plan contribution and had used the monies, while the plan was in "excess surplus," for one-time-only purposes. Ms Brown confirmed that the University continued to budget 75% of the current service cost of the plans. The first call on this money was to set aside funds to match the accrued liability in the Supplemental Retirement Arrangement. The University used a part of its benefits budget to set aside funds each year sufficient to match the current service cost of the S.R.A. It also used the money freed up in that budget from pension contribution savings to increase the amount set aside to match the past service cost. The University planned to increase this special fund sufficiently to match the accrued liability fully. The special fund was invested in the University's Long-Term Capital Appreciation Pool, the same pool used for the endowment funds. The Chair observed that the recent market decline, if exacerbated by current geo-political problems, might force a resumption of University contributions to the pension plans.

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

YOUR COMMITTEE RECOMMENDS

THAT the audited financial statements of the University of Toronto Pension Plan, June 30, 2001, a copy of which is attached hereto as Appendix "C", be approved, and

THAT the audited financial statements of the University of Toronto (OISE) Pension Plan, June 30, 2001, a copy of which is attached hereto as Appendix "D", be approved.

5. Chair's Remarks

The Chair welcomed members to the first meeting of the Audit Committee for 2001-02. He introduced Mr. Felix Chee, who had become Vice-President - Business Affairs on October 15, 2001. Mr. Chee would serve as the Committee's senior assessor. The Chair drew members' attention to the Committee's terms of reference, which described the Committee's responsibilities. (A copy of the terms of reference had been placed on the table for the meeting.) The calendar of business, which outlined the items planned to come before the Committee during the year, appeared later on the agenda. The Committee normally met in closed session. That meant that meetings were open only to members, as well as any members of the Business Board or Governing Council who might wish to attend. In addition, appropriate members of the University staff would be invited to attend. From time to time the Committee would move *in camera* to discuss particularly sensitive matters off the record. In those cases, only members and specified staff would attend. The Committee received a great deal of confidential material.

5. Chair's Remarks (Cont'd)

Some items would become public after the Committee had dealt with them, such as the University's financial statements. Other material, however, would remain private, such as the Internal Audit plan. The Governing Council's "Guidelines on Confidentiality of Documents and Proceedings" stated that all proceedings taking place in closed session were not to be discussed outside of the Committee, except with people who would be entitled to attend the meeting - other Committee members, Business Board members or Governing Council members. Appropriate documentation and the record of the Committee's proceedings would be released by the Secretariat in accordance with usual practice or the Chair's instructions. Members were, therefore, asked to treat the information they received as members, and the Committee's discussions, with a high level of discretion.

6. Business Arising from the Report of the Previous Meeting: External Auditors' Independence Letter

The Chair recalled that at the June 20, 2001 meeting, during the discussion of the audited financial statements, Mr. Bowman had told the Committee that the Canadian Institute of Chartered Accountants had initiated a requirement that external auditors submit to audit committees a letter providing assurance of their independence. He had at the time given oral assurance that there were no matters that would impair Ernst & Young's independence or their audit opinion, and he undertook to deliver a letter to that effect the following day. A copy of that letter had been received and was enclosed in the agenda package.

7. Business Arising from the Report of the Previous Meeting: External Auditors' Information Technology Management Letter to the Administration and Administrative Response

The Chair recalled that at the June meeting, the Committee had reviewed the external auditors' management letter arising from the 2001 year-end audit. At that time, Mr. Bowman and Ms Brown had reported that the external auditors had prepared a supplementary letter to management containing recommendations concerning the University's computer systems and a general recommendation for a business-recovery plan. The Committee had asked that a copy of the letter be provided, and it was included in the agenda package, along with the administration's response. In addition, a broader matter had arisen - that of an overall risk assessment, including areas of exposure other than electronic systems. The administration was working on such an assessment, and it would be on the agenda of the November 28 meeting.

Mr. Chee noted that the auditors' memorandum to management and the administrative response, dealing with specific components of the University's systems, were often quite technical. The issue of a disaster recovery plan would be dealt with later, and it should be seen in the context of a broader business recovery plan. One important factor was the substantial increase in decentralized computing and administration. The matter would be evolving, and it was Mr. Chee's intention to cover all bases and bring a report back to the Committee and to the Business Board.

Mr. Kemp observed that the external auditors' letter dealt with many technical issues. By and large, the administration agreed with the auditors' comments, and it had implemented the recommended changes. The University was redesigning its security systems, and Mr. Kemp and his colleagues would give careful consideration to the auditors' recommendations in the implementation of the new security methodology. The biggest question raised in the auditors' letter was the matter of disaster recovery. The University did back up all files from its central

7. Business Arising from the Report of the Previous Meeting: External Auditors' Information Technology Management Letter to the Administration and Administrative Response (Cont'd)

systems and stored the back-up data off-site. However, the University had no alternative location for computing staff in the event of fire or other event. Mr. Kemp was therefore preparing a costed proposal for a backup location for operations for both the Administrative Management Systems (A.M.S.) and the student record system (the Repository of Student Information or ROSI). That proposal would be considered by senior management. He had also discussed the matter with the Library and the Faculty of Dentistry. While the costed proposal would not include amounts for the Library and the academic divisions, the recovery plan itself would be institution-wide.

A wide-ranging discussion took place, which included consideration of the following matters.

(a) Forthcoming risk assessment. In response to questions, Ms Brown confirmed that one of the topics included in the risk assessment was loss of facilities owing to fire or other occurrence. Computer disaster and the loss of facilities to fire or other event were, however, only two of the elements of the broad risk assessment. The subject of business resumption after a terrorist act had arisen at the previous meeting of the Business Board. Dr. Levy, in his role as Acting Vice-President - Business Affairs, had undertaken that the administration would report back to the Board on the matter. The University certainly had good plans in place for emergencies of various sorts. A key element of disaster planning was communications to members of the University. It was fortunate that the recently appointed Manager of Police Services, Mr. Dan Hutt, had extensive experience in emergency planning with the Toronto Police Department. Mr. Chee stressed that the risk-assessment was at a high, strategic level. Various members of the University staff were assisting in identifying risks, determining the control measures that were in place, and identifying the residue. One matter of concern to Mr. Chee was the loss of research and teaching data in the event of fire or flood. While data on the University's central computers were being backed up and stored off-site, the central administration had no knowledge about the back up of data on personal computers.

Ms Brown said that the risk assessment would list areas of risk, identify the committee in the governance system with responsibility in the area, identify the administrative officers responsible for the area, list the factors mitigating the risk, rate the remaining unmitigated risk as high, moderate or low, and provide comment as appropriate. Mr. Chee stressed that the most important aspect of the risk assessment would be its effect on mindset in the University - making members of the University cognizant of the need to identify and mitigate risks in various areas.

(b) Reduction of risk through contracting out. A member observed that many firms used external service providers for such services as payroll. Those firms were well positioned to survive problems such as fires with data backed up and operations possible from other locations. Mr. Chee and Ms Brown replied that, in the particular case, the University's payroll was far more complex than that of a private-sector firm and any contractor would have to develop so much customization that external service would be prohibitively expensive. In addition, the Human Resources system was fully integrated with the financial information system, which provided many advantages with respect to controls.

(c) External auditors' view. Invited to comment, Mr. Bowman noted that the question of disaster recovery had formed a topic of conversation between the auditors and the administration

7. Business Arising from the Report of the Previous Meeting: External Auditors' Information Technology Management Letter to the Administration and Administrative Response (Cont'd)

since 1989. The administration's response had previously been to acknowledge the problem but to cite the cost of remedial action and to indicate that, with severely limited resources, other needs had to be given a higher priority. The current view was different. With respect to information technology, data were being backed up and the back-up data stored off-site. Other actions were being taken or considered. The auditors were therefore satisfied with the administrative response to the recommendations concerning information-technology disaster.

(d) Role of the Audit Committee. The Chair commented that he was uncertain of the Committee's role. Clearly, it would hope to receive assurance from the administration that, at least in most areas, there was no material exposure and that the University would be able to carry on in the event of an adverse occurrence. If, on the other hand, it was clear that there were areas of material risk, the Committee might wish to express a view about the need for action. Mr. Chee urged that the Committee proceed systematically, beginning with the review of the broad risk assessment. It would be appropriate to consider how to proceed only after consideration of that assessment. Two members strongly commended that approach. A member commented that while various committees of the Governing Council might well have responsibility for monitoring risk in specific areas, there was still need for one body to have general oversight to ensure that no matter would "fall between the stools." The Audit Committee had played that role with respect to preparations for the transition to the new millennium (Y2K), but the Committee might not be the appropriate one in this case. Mr. Charpentier undertook to review the terms of reference to consider the appropriate location of such responsibility. His initial view was that either the Executive Committee or the Audit Committee would appropriately take responsibility for the overview the member described. The Chair concluded that the Committee should await the risk assessment. If there were areas of exposure, it might wish to add its voice to support for remedial action. He concluded that the Committee was willing to accept the advice of the Vice-President - Business Affairs that that was the best way to proceed.

8. Business Arising: Internal Audit Resources

The Chair recalled that at the May meeting, the Committee had "AGREED that the Chair communicate to the President the Audit Committee's strong view that the Internal Audit Department should be provided with the resources necessary to ensure that high-risk units be subject to an annual review." The Chair reported that he had met with the President in June, had conveyed the Committee's pleasure with a number of new initiatives such as the program of accountability reports and also with the reporting from the Internal Audit Department. The Chair had also stressed the importance of the President and his administration's supporting the Internal Audit Department's work to creating a climate conducive to strong internal financial controls. In particular, it was important that the Internal Audit Department have the resources necessary to review at least all high-risk units at least annually. The President had expressed support and recommended that the Committee's view be conveyed to Mr. Chee. The Chair indicated that he had had an opportunity to convey those thoughts to Mr. Chee for his consideration. .

9. Legal Services: Summary Report, 2000-01

The Committee received, for information, the annual report on legal services for 2000-01. The Chair noted the key reason for the Audit Committee's receipt of the report: it could help the Committee to identify areas of potential liability.

9. Legal Services: Summary Report, 2000-01 (Cont'd)

Mr. Chee observed that while spending on legal services for 2000-01 had been well over budget, the spending was driven by events which would invariably bring about variances from the budget.

A member asked whether the University had made any provision for a contingent liability arising from legal actions. Ms Brown replied that a careful analysis was completed in connection with the audit of the annual financial statements, with the auditors receiving letters from the University's legal counsel about contingent liability. For 2001, the financial statements had reported that "the University believes it has valid defenses and appropriate insurance coverage in place" with respect to all pending legal action. "In the unlikely event any claims are successful, such claims are not expected to have a material effect on the University's financial position." The Chair observed that, in the light of the fact that this review took place in connection with the audit, the administration should consider bringing future reports on legal services forward at the same meeting as the financial statements.

10. Enrolment Audit, 1999 - 2000

The Committee received for information the enrolment audit for 1999-2000. The audit was performed by the external auditors for the Ministry of Training, Colleges and Universities to verify the enrolment data provided to the Ministry as the basis of the University's claim for operating grants. While the Audit Committee was not responsible for monitoring enrolment, it was responsible for reviewing financial reports and audits of them.

A brief discussion took place. A member suggested that the University consider the preparation of data to understand the net cost of providing training to students in various programs. Ending or reducing enrolment in some areas would presumably provide more savings than doing so in others, and initiating or expanding in some areas would presumably generate more net income or add less cost than other areas. While decisions about the allocation of University resources would, of course, be based on academic criteria, net cost data would nonetheless provide very valuable information for decision-making.

The Chair proposed, and it was AGREED, that the Committee would henceforward carry out its responsibility for monitoring this audited report, and other small audited reports, by placing them on a new "consent" portion of the agenda. Members would receive the reports with their agenda packages or in advance of them. They would be asked to review the reports carefully and, before the meeting, to call the sponsor with any questions for clarification. The name and telephone number of the sponsor would be shown on the "green sheet" covering the item. If any member had concerns about an item, the member would notify the Committee's Secretary well in advance of the meeting. The item would be flagged for discussion by the Committee, and the Secretary would notify the relevant administrative assessor in advance so that any appropriate staff members could be asked to attend for the discussion. For items where no member gave notice of a wish for a discussion, the items would be dealt with quickly with no introductions and (usually) with no discussion, although questions or comments would not be ruled out of order. The Chair assured a member that the enrolment audit, and any other audit presented to the Committee as a consent item, would be in areas of low risk.

11. Report of the Administration

Mr. Chee, Ms Brown, Mr. Charpentier, and Mr. Britt stated that they knew of no other matters that should be drawn to the attention of the Committee.

REPORT NUMBER 62 OF THE AUDIT COMMITTEE - November 7, 2001

12. Calendar of Business, 2001-02

The Committee received, for information, its Calendar of Business for 2001-02. The Calendar set out the business planned to come before the Committee for the year. Of course, developments could well result in additional items that would require the Committee's attention.

13. Date of Next Meeting

The Chair reminded members that the next regular meeting was scheduled for Wednesday**,** November 28, 2001 at 5:00 p.m. That meeting would (among other things) a review the interim report of the Internal Auditor and a review the risk-assessment report.

The meeting adjourned at 7:40 p.m.

Secretary	Chair

November 21, 2001