UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 55 OF THE AUDIT COMMITTEE

November 24th, 1999

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, November 24th, 1999 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
Mr. Roger P. Parkinson
Dr. Marlene Puffer
Ms Penny Somerville

Mr. Robert G. White, Chief Financial Officer

Mr. Mark L. Britt, Director, Internal Audit Department

Secretariat:

Mr. Neil Dobbs
Ms Susan Girard

Regrets:

Ms Wanda M. Dorosz
Ms Christine A. Capewell
Professor Wally Smieliauskas

In Attendance:

Mr. Keith B. Bowman, Ernst & Young
Ms Sheila Brown, Controller and Director of Financial Services
Mr. Stuart J. Budden, Treasurer and Director of Investments*
Professor Jack Gorrie, Provost's Special Advisor on Information Technology**
Ms Laurie M. Lawson, Assistant Treasurer*
Mr. Michael Moore, Audit Manager, Internal Audit Department
Mr. Pierre Piché, Associate Controller
Ms Deborah E. Simon-Edwards, Executive Assistant to the Chief Financial Officer
Mr. Allan H. Shapira, Hewitt Associates*

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

REPORT NUMBER 55 OF THE AUDIT COMMITTEE - November 24th, 1999

ITEM 2 CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD FOR APPROVAL

1. Report of the Previous Meeting

Report Number 54 (October 13th, 1999) was approved.

2. Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999

The Chair noted that the Audit Committee's duty with respect to this pension plan 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. The Committee was also asked to recommend the two sets of financial statements to the Business Board for approval prior to their submission to the Financial Services Commission of Ontario.

Mr. White reported that the annual stewardship report dealt with three retirement arrangements: (a) the main pension plan; (b) the pension plan for employees who had begun their plan membership as employees of the Ontario Institute for Studies in Education before its merger with the Faculty of Education within the University of Toronto; and (c) the Supplementary Retirement Arrangement. The report included: a general description of the plans, the audited financial statements for the two registered pension plans, an excerpt from the actuarial report on the two registered plans, a report on the Supplementary Retirement Arrangement, and a report on investment performance. While an annual report on all investments for year ended December 31st was submitted to the Business Board each spring, a special report on pension investments to June 30th was, for the sake of completeness, submitted as a part of the annual stewardship report on the pension plans. Mr. White noted that copies of the complete actuarial report would be made available to the Faculty Association and to any member of the Committee who wished to receive one.

Mr. White reported that the actuarial surplus in both plans had grown slightly from the end of the previous fiscal year. The financial statements had received a clean audit report. A number of changes had been made in the actuarial assumptions, which had the effect of increasing the surplus, but only slightly, and reducing the current service cost, again only slightly. The changes had followed careful consideration, and the actuaries' decision had been fully supported by the University administration.

Mr. Shapira reported the highlights of the actuarial valuation and responded to questions.

- **Benefit improvements**. The valuation reflected the benefit improvements, effective July 1st, 1999, which had emerged from the negotiations with the Faculty Association. Those benefit changes had been extended to the non-unionized administrative staff. The University remained in negotiation with the Steelworkers' union and other unions, and it was possible that further changes might still emerge that would affect the valuation.

- **Actuarial surplus**. The surplus in the main plan had grown from $327-million as of July 1st, 1998 to $352-million as of July 1st, 1999.

  Mr. Shapira cautioned, however, that the University itself had a substantial liability on account of the Supplementary Retirement Arrangement (S.R.A.). The University planned to set aside sufficient money to match its future obligations under this arrangement, moving to establish a reserve to equal the accrued liability by 2004. The liability on account of the S.R.A. as of July 1st, 1999 was about $102-million. Mr. Shapira stressed that the monies

set aside to match the University's obligations under the S.R.A. were merely included in the University's own "funds committed for specific purposes." There were not, and under law could not be, separate trust assets like those in the pension plans. To July 1st, 1999, the University had set aside just over $57-million to meet its S.R.A. obligations, launching it

2. <u>Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999</u> (Cont'd)

well on its way to having full funds to match its liability. Because its registered pension plans were fully funded, the University was not allowed to make current service contributions to those plans, and it directed a substantial part of its pension-contribution budget toward the S.R.A. reserve.

In response to a question, Mr. White said that it had been planned to build up the reserve to a level to match the S.R.A. liability fully by 2002. Given the recent plan improvements, it would take longer to do so. The University would follow its usual policy of amortizing the new level of the liability over five years, achieving its objective by 2004.

In response to a question, Mr. White said that it was entirely permissible to take a number of years to build up the reserve. In fact, there was no obligation whatever to build up such a reserve. Most private-sector employers met their S.R.A. obligations on a pay-as-you-go basis. When the University first established the S.R.A. in 1997, however, it had decided that it would be prudent to set aside funds within its accounts to match this obligation, building up the reserve over five years.

The Chair noted it was important, in looking at the University's overall liability for the pension plans plus the S.R.A., to note that the calculation on page 63 took into account a 5%-of-assets surplus reserve for the pension plan but not for the S.R.A.

- **Actuarial valuation of the assets**. The Chair noted that the actuarial valuation showed that the surplus reserve (which was 5% of the actuarial value of the assets) had increased as at June 30th, 1999 in spite of the fact that the fund had earned an investment return of only 2.5% for the year. Mr. Shapira replied that the actuarial valuation smoothed the peaks and valleys of the securities markets over three years. Owing to the 14.8% investment return in 1997-98 and the 21.3% return in 1996-97, the market value of the fund was still substantially higher than the actuarial value. The cushion between the market value and actuarial value was $207-million as at July 1st, 1998. Then, owing to the cash-flow out of the fund to pay pensions, and the low level of contributions (only members of the S.R.A. continued to make plan contributions during the holiday), and owing to the lower-than-assumed investment returns, the cushion between the market value and the actuarial value had declined to
  $82-million as at June 30th, 1999. If investment performance continued to lag the actuarial assumption of inflation plus 4% per year, then of course the cushion would be lost and eventually the actuarial surplus and the surplus reserve would decline.

- **New actuarial assumptions**. Mr. Shapira said that the actuarial assumption concerning the annual increase in the Consumer Price Index (C.P.I.) had been reduced from 4.5% per year to 3% per year to give more weight to the experience of recent low-inflation years.
  The C.P.I. or inflation assumption was the basis for the other key assumptions:
  (a) on the liability side, salary increases and therefore benefit increases, and (b) on the asset side, the return on investment, described as the “interest rate.” The most important

aspect of the assumptions was, therefore, the relationship between the salary-increase assumption and the interest-rate assumption. The valuation continued to assume that salaries would increase at the rate of inflation plus 1.5%. The valuation now assumed that the interest rate would be inflation plus 4.0%, rather than inflation plus 3.5% as previously. While actuarial

2. Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999 (Cont'd)

assumptions were conservative and based on long experience, the change had been made to give greater weight to the experience of recent years when real investment returns had been higher. The outcome of the changed assumptions had been minor, reducing the accrued liability by less than 1% and reducing the current service cost by about 2%. In response to a question, Mr. Shapira said that the actuarial assumptions for other major plans had also been revised, with the inflation assumption often being 2.5% or 3% and the real-return or interest rate assumption being between 4% and 5%.

In response to a member’s question, Mr. Shapira recalled that previous changes in the assumptions had taken place as at July 1st, 1991, when the interest-rate assumption had been increased from C.P.I. + 2.5% to C.P.I. + 3.0%, and as at July 1st, 1997, when the interest-rate assumption had been increased to C.P.I. + 3.5%.

- **Supplementary retirement arrangement**. In response to a question, Mr. Shapira said that the University’s liability on account of the S.R.A. had been $78-million as at July 1st, 1999, before changes. The benefit changes had brought about an increase in that liability to $98 million. That increase was a large one because benefits in the supplemental arrangement were not, by their nature, limited by the maximum pensionable earnings established by Revenue Canada for registered plans. (Of course, it was the very fact of the limit, and the long delay in indexing that limit to inflation, that had forced the University to establish the supplemental plan to be able to keep its pension promise to higher paid employees.) The change in actuarial assumptions, in particular the inflation assumption, had brought about a further increase in the liability to $102-million.

  Mr. Shapira noted that the affect of the changes in assumptions had therefore been to reduce the accrued liability of the registered plans by $10-million and to increase the liability of the University on account of the supplementary arrangement by $4-million. The overall effect of the changes in the assumptions was, therefore, a net reduction in liabilities of $6-million.

- **Current service cost**. Each year, there was a current-service-cost obligation for the plans that had to be funded either by contributions or from the plan's surplus. That cost was the estimated present value of the future benefits earned by active (non-retired) members of the plan during the forthcoming year, discounted by the assumed interest to be earned on that amount. That cost for the main plan was $49-million for 1999 - 2000. If the plan were not in a surplus position, and if there were no employee contribution holidays, then participants would be required to contribute $18-million and the University $31-million. Because there was an “excess surplus” in the plan, according to the Income Tax Act, the University was not allowed to make an employer contribution. Instead, it used a substantial part of the money budgeted for the pension funds for the committed-funds account set aside to match the University’s obligations under the S.R.A. Mr. Shapira reported that the OISE plan had a current service cost of $2-million. In addition, the University would want to commit an additional $4.5-million to match its current-service obligation under the Supplementary

Retirement Arrangement. In total, the current-service cost of both pension plans and of the funds committed to match the S.R.A. obligation amounted to about 9.5% of total payroll.

2. Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999 (Cont'd)

Substantial discussion developed concerning the investment performance of the pension fund. In the course of discussion, Mr. Budden and Ms Lawson replied to a number of detailed questions. More general discussion arose from the concerns about investment performance expressed by a number of members. One member noted that the main pension fund had a return of 2.5% for the year ended June 30th, 1999, which fell far short of the 22.4% return of the Standard and Poor's 500 Index of large U.S. stocks. Given the large size of the funds, such underperformance had a very large cost to the University. In response to a question, Mr. Budden said that the pension fund's four-year average annual rate of return was 12.6%, which fell short of the policy benchmark of 13.9% and also fell short of the median return of comparable Canadian funds, which was 13.4%.

Mr. White replied that the performance had not been satisfactory to the President's Investment Committee, to him as Chief Financial Officer or to the Treasurer. It was, however, inappropriate to compare the performance to the Standard and Poor's 500 Index. Canadian pension funds were limited to investing 20% of their assets in foreign markets.

Mr. Budden said that the benchmark for the pension funds consisted of a composite of the security indices that formed the asset mix of the fund: the Scotia Capital Markets Universe Bond Index weighted at 40%, the Toronto Stock Exchange 300 Index weighted at 40%, the Standard and Poor's 500 Index of U.S. stocks weighted at 10% and the Morgan Stanley Capital Inc. Europe, Australasia and Far East (EAFE) Index weighted at 10%. That asset mix was based on a careful analysis of the liabilities of the pension plan, with the bond component designed to ensure sufficient safety and stability and sufficient cash-flow to make $65-million of annual payments to current pensioners as well as $9-million of payments to the beneficiaries of deceased pensioners, payments for transfers to other plans, etc.

Mr. Budden added that the benchmark, and the actual asset mix of the pension fund, necessarily took into account the 20% foreign content limit on Canadian pension plans. Although the University's fund was moving to increase foreign content through the use of derivative investments, it was unreasonable to compare the pension fund's performance with the Standard and Poor's 500 Index. During the year ended June 30th, 1999, the Toronto Stock Exchange 300 Index had declined by 3.3%. The Scotia Capital Markets Universe Bond Index had gained only 4.3% for the year. It was also unreasonable to use short-term performance as the basis for judgements.
Mr. Budden noted that shortly after his arrival at the University, the pension fund had ranked in the 96th percentile. Relative performance had been improving, with performance for the year ended June 30th, 1999 in the 74th percentile. While that performance was not yet satisfactory, steps were being taken to improve it. Because most active portfolio management firms were failing to outperform their benchmark indices, Mr. Budden was proposing to the President's Investment Committee a further increase in the proportion of the funds to be invested passively in index funds to 80% of all equities as well as the current 100% of all bonds. In addition, the active management firms that had underperformed their benchmark indices over a full market cycle had been replaced. In an effort to enhance return without undue risk, the President's Investment

Committee did establish a tactical asset mix each year that usually differed slightly from the benchmark mix, and the tactical asset-mix decision had most often added value. The Committee had been using derivatives to increase the funds' investments in foreign equity indices beyond the 20% of actual foreign investments permitted by the Revenue Canada regulations and included in the benchmark. That too had helped performance, but it was imprudent to make those moves suddenly. For example, for the 1999 calendar year to October 31st, 1999, the T.S.E. 300 Index (with a return of 13.3%) had outperformed the U.S. Standard and Poor's 500 Index (which had earned only 7.5%).

2. **Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999** (Cont'd)

In response to a question, Ms Lawson said that the pension fund had earned an estimated return of 4.3% for the ten months of 1999 to October 31st.

During the course of discussion, a member commented that poor investment performance in the endowment fund caused an additional problem: potential benefactors would be less inclined to donate to the endowment. Mr. Budden replied that the University's endowment, which was not bound by the foreign content rules, had in fact performed exceptionally well. Over the four years ended June 30th, 1999, the Consolidated Investment Pool (the investment vehicle for both the endowments and the funds set aside to match the University's obligation under the S.R.A.) had ranked in the 17th percentile among the approximately 1800 comparable funds measured by S.E.I. Investments' comparative measurement service.

During the course of discussion, a member commented that the report did not provide information concerning the economic risks to which the fund was subjected. There was no clear indication of the amounts invested in various markets. She asked whether this information was made available to, and monitored by, the President's Investment Committee. Ms Lawson assured the member that the Committee received detailed monthly reports on allocation among asset classes, among equity markets, among portfolio managers, and between active and passive management, as well as detailed information concerning investment returns. Mr. Budden added that the firm Portfolio Analytics was engaged to prepare attribution analyses and measurements of value at risk, both regularly presented to the President's Investment Committee.

The Chair commented that it was clear that members of the Audit Committee took seriously the question of the investment performance of the pension funds, as did members of the President's Investment Committee. Among the responses to poor performance had been the move to invest more of the pension and endowment funds passively in index funds, which had in recent years been outperforming active managers. In addition, the administration had proposed, and the Governing Council had approved, organizational changes concerning investments. Because several members of the Audit Committee were not members of the Governing Council or the Business Board, the Chair invited Mr. White to describe the forthcoming changes.

Mr. White reported that the Governing Council had recently approved the establishment of a separate University of Toronto Investment Management Corporation. A search was being conducted, both internally within the University and externally in Canada and elsewhere, for the President of the new corporation. The Chair of the President's Investment Committee had concluded that delegation of responsibility to a new corporation would allow for faster decision-making. The new corporation would be governed by a Board of Directors with full trustee responsibility, somewhat different from the responsibility exercised by the President's Investment Committee. Its staff of perhaps 15 to 18 individuals would represent a substantial increase from the staff in the Treasury Department now dedicated to investment management. The new company would be responsible solely for investment management, with other Treasury Department functions remaining with the University. The larger staff, and the greater focus within a professional investment company, would enable the new organization to keep a more

careful watch on the external portfolio managers, complete more analytical work, monitor investment-management developments elsewhere, and actively seek out new investment vehicles. Mr. White said that he would be pleased to distribute to members of the Audit Committee the recently approved proposal to establish the new corporation. While it was true that a 1% increase in investment returns would yield the University $35-million more per year, he cautioned that members should not expect a sudden improvement in relative performance. But, Mr. White was confident that, over the long term, performance would improve. Clearly, the President's Investment Committee, the senior

2. Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999 (Cont'd)

administration including the Chief Financial Officer, and the Treasurer were not satisfied with investment performance at the present time.

The Chair noted that the investment returns of the University's plan and the OISE plan had differed significantly. Mr. Budden explained that because of the much smaller size of the OISE plan, its management had not been as diversified as the University-wide plan. For example, all of the active Canadian equity investments had been managed by a single firm. That firm's returns had been poor over the twelve months ending March 1999, when the OISE fund had been rebalanced to mirror the University-wide fund as closely as possible.

The Chair referred to the use of derivative instruments and recalled problems that had caused large losses in certain other funds using such instruments. Mr. Budden and Ms Lawson replied that the problems that had taken place elsewhere had arisen because those funds had used derivatives for purposes of leverage. The University's investment policies prohibited portfolio managers from using leverage. The derivative investments used for the pension funds involved no leverage whatever. Foreign stock-index future contracts were used and every penny of exposure was backed by money invested in safe short-term money-market instruments: government treasury bills, government-guaranteed short-term paper, and very high-quality commercial paper. The futures contracts were marked to market daily and exposures were adjusted daily to match the backing assets. There was, therefore, not significantly greater risk involved in the use of those instruments than in investments in the underlying security indices.

The Chair observed that note 3 to the financial statements recorded a net currency-exchange loss of $1.1-million. He asked about the University's policy concerning hedging against currency losses. Ms Lawson explained that the largest part of the currency loss had been the result of a one-time event. A portion of the University's passive investment in the Standard and Poor's 500 Index of U.S. equities had been included as part of a pooled fund located in the U.S.A. Because of changes to U.S. tax practices, a portion of the earnings from this $148-million investment would have been made subject to U.S. withholding tax, notwithstanding the University's status as a tax-exempt institution. As a result, the management firm, which had international operations, had established a new S&P 500 pool located in Canada, and it had recommended that the University move its investment to that new pool. During the short period of time when the investment was being moved, the currency loss had taken place. Because the amount moved involved was so large, even a relatively small currency change had caused a substantial dollar loss.

On the broader subject of currency hedging, Mr. Budden explained that the President's Investment Committee had hedged only a small portion of the foreign equities against currency loss, and it had recently decided to forego hedging entirely, except in special circumstances.
On the basis of a paper by a leading expert, Professor Lawrence Booth of the Rotman School of Management, the Committee had accepted that active management of currency exposures did not in the long run, after paying costs, add value. Therefore, the Committee had decided that foreign

exposures should be monitored and hedged only if there was a risk of some major realignment in currency values, most often as the outcome of political or economic instability.

2. **Pension Plans: Annual Financial Report Including Financial Statements for the Year ended June 30th, 1999** (Cont'd)

On the recommendation of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

THAT the audited financial statements of the University of Toronto Pension Plan for the year ended June 30th, 1999 be approved, and

THAT the audited financial statements of the Ontario Institute For Studies in Education Employees' Pension Plan for the year ended June 30th, 1999 be approved.

3. **Year 2000 Preparedness**

(a) **Professor Gorrie's Report**

Professor Gorrie said that there had been only one change of status in divisional readiness since his November 5th, 1999 report.

- **Faculty of Applied Science and Engineering**. The Faculty had now moved to level 2 readiness, defined as "all major systems ready now. Some smaller systems are still under review, but none has a significant impact on the administrative, teaching or research activities of the division."

As a result, all central systems were year-2000 ready and only six divisions remained on Professor Gorrie's list of divisions that had not reported at least level-two readiness. The divisions that had not reported compliance were as follows.

- **Faculty of Dentistry**. The Faculty had reported orally that it was ready for the year 2000. Its new clinical system had been installed and had been functioning for some time. Some software upgrades for other minor systems were still required.

- **St. Michael's College**. Four units within the College had decided not to participate in the University-wide year-2000 preparedness exercise. Because St. Michael's College was a separate corporation affiliated with the University of Toronto through two memoranda of agreement, the College was free to look after its computer-system needs on its own. The Vice-President and Provost was aware of the College's decision, and he had agreed that it would be inappropriate for Professor Gorrie to do more than offer his assistance. Professor Gorrie did not anticipate any problems at that College that would cause any embarrassment to the University. St. Michael's College Arts and Science students were registered through the University-wide student-records system, which was fully compliant. St. Michael's P.B.X. telephone system was also compliant. Any problems of transition to the year 2000 would therefore be limited to personal computers or to the four units within the College.

The College did have a year-2000 coordinator, who appeared to be confident about the College's position.

- **Faculty of Medicine**. The Faculty remained at level three, with four of its units not ready, a reduction of one unit from the previous report. The Faculty's old VAX system, which was not compliant, had been turned off, with the result that undesirable shadow accounting systems were no longer functioning. The remaining non-compliant departments

3. **Year 2000 Preparedness** (Cont'd)

(a) **Professor Gorrie's Report** (Cont'd)

were small ones, and the Chief Administrative Officer of the Faculty and Professor Gorrie would continue to press them to take the necessary actions.

- **School of Continuing Studies**. The School had put back its target date for compliance. Its new, fully compliant student registration system was now in place and had been operating successfully for two weeks. The problem was migrating the financial information from the registration system into the University's Financial Information System. The external contractor handling the installation had promised that the problem would be remedied in one week. If it was not remedied by the end of the year, the School had a contingency plan involving manual processing of the financial information, which could be carried on for some time, if necessary.

- **Innis College** had not moved its target date forward from December 31st, 1999. Again, its major student-registration and financial operations used the compliant University-wide systems, and the College's in-house operations were modest.

- **Faculty of Music**. With the aid of $35,000 of special funding allocated by the Vice-President and Provost, the Faculty was purchasing new equipment. The Faculty was also receiving assistance from the Computing and Network Services Department with respect to the installation of the new equipment. Professor Gorrie anticipated no problem.

Professor Gorrie reported that testing on all central systems, including testing that incorporated trial roll-forwards of the date into the year 2000, had been completed, and the systems were fully able to accommodate the transition to the new millennium. Professor Gorrie concluded that the University was ready for the year 2000 and that its operations would continue without significant disruption and without embarrassment arising from any inability to continue its public functions.

Professor Gorrie reported on contingency plans for the first days of the year 2000. Extra staff would be on hand from December 31st, 1999 to the resumption of usual activities on January 3rd, 2000. They would ensure the continued functioning of utilities. Emergency generators would be turned on two hours before the new year just in case of any electrical failure. Staff would also be on site in the event of any need to restart systems manually, for example refrigeration systems that would shut down in the event of any power disruption. Police staff would also be on hand on all campuses. In the worst case, the dates on control systems would be backed up to ensure continued functioning.

(b) **Internal Audit Report**

The Chair recalled that the Internal Audit Department had for the past several months been verifying the information reported to Professor Gorrie; the Department had done so in the course of its regular audit testing and in special testing. The Department's preliminary report had

been presented to the Committee at its previous meeting, and Mr. Moore had provided an oral update. Members had received in their agenda packages the final report on the year-2000 audit as well as a supplemental report.

Mr. Britt reported that the Internal Audit Department had been focusing its efforts since its September 1st report on mission-critical systems - both central systems and those in the divisions. The "Internal Audit Report #2, Year 2000 Readiness," dated November 15th, 1999, dealt with the

3. **Year 2000 Preparedness** (Cont'd)

(b) Internal Audit Report (Cont'd)

responses to the Department's recommendations made in its September 1st report. With respect to the readiness of the central systems, the results of the reviews were positive, and their readiness had since been verified by testing. Similarly, the actions recommended with respect to systems in Simcoe Hall and the Human Resources Department had been dealt with satisfactorily.

Mr. Britt explained that the "Internal Audit Report #2 . . .," concentrating on follow-up work, had not included the results of other, ongoing work completed between September 1st and November 15th, 1999. He had therefore prepared a supplementary report to deal with the Department's other ongoing reviews. Those reviews had focused on the divisions that Professor Gorrie had reported as below level-two readiness. The internal auditors had met with the year-2000 coordinators and unit heads in those divisions to identify the mission-critical and the non-mission-critical systems. In some cases, the auditors had found that the division was ready but had not reported its readiness to Professor Gorrie. The Internal Audit Department's conclusion was that, with two exceptions, all of the University's mission-critical systems were year-2000 ready. The two exceptions were the School of Continuing Studies and the inventory-control system of the Department of Physics' stores operation. Those units were dealing with their problems, expected to have solutions in place before the end of December, and had satisfactory contingency plans to deal with any failure.

A member asked whether there would be revenue implications if the School of Continuing Studies failed to achieve year-2000 readiness. Mr. White, Professor Gorrie and Mr. Moore replied that there would be no loss of ability to process registrations and therefore no loss of revenue. The School's registration software was compliant and operational. The problem was the migration of information from that system to the University's Financial Information System. That step could be handled, if the new programming did not work, by non-date-sensitive parts of the old system combined with some manual work. The Director of the School had thought that the difficulty and cost involved in implementing the contingency plan would not present a serious problem.

The Chair noted that following Professor Gorrie's early-November report, he (the Chair) had concluded that the University had made real progress in achieving year-2000 readiness, especially given the realities of its decentralized environment. He had continued to be disturbed by those few units that had failed to meet their planned dates for achieving compliance, had failed to submit reports to Professor Gorrie, and had failed to develop contingency plans. The Chair was now pleased to learn that that most of those units had achieved compliance, including the Faculty of Music and the remaining departments in the Faculty of Medicine. There was no assurance the four departments in St. Michael's College would be ready for the year 2000, but the University was powerless to act. The School of Continuing Studies and the stores unit in the Department of Physics were on track to achieve compliance and had contingency plans. The Chair urged that, in order to avoid embarrassment to the University as a whole, every possible action be taken to ensure that those units achieved readiness. With respect to the central systems, all necessary action and testing had been completed satisfactorily. He thanked the Committee for

the diligence with which it had attacked this problem. He hoped that the Committee's attention to the matter had been useful in moving solutions forward. He thanked Professor Gorrie, Mr. Britt, Mr. Moore,
Mr. White and all of the members of the University who had been ultimately responsible for completing the work necessary to make the University year-2000 compliant. While it would be impossible to be completely comfortable until January, 2000, the prospect was encouraging, and the Chair expressed the Committee's appreciation.

3. **Year 2000 Preparedness** (Cont'd)

(b) **Internal Audit Report** (Cont'd)

A member suggested that there be a follow-up report in the new year to report on the outcome of the year-2000 effort. There remained questions with respect to certain units, the possible need to implement contingency plans, and the readiness of systems that were not mission-critical. In addition, there were concerns about the ability of the systems to handle the date February 29th, 2000 - an atypical date because of the leap year. Professor Gorrie agreed that an additional report would be in order. Problems might well appear in infrequently used systems that were not put to the test until some time into the new year. Other subtle problems might well also not appear for some time, even in frequently used systems. Of course, in those cases, problems would be remedied as they appeared. The Chair agreed that a follow-up report would be appropriate, perhaps as at January 30th and again at the Committee's next meeting. If any serious problem were to appear, the Chair undertook to communicate with the Committee at an earlier date.

4. **Internal Audit: Risk-Assessment Process in Preparing the Annual Audit Plan**

Mr. Britt said that the University's administrative practices had evolved over the years, all the more with the recent introduction of the new Administrative Management Systems. Therefore, the Internal Audit Department's risk-assessment database required change in order to reflect the new risks. The preparation of the new database involved two steps. First, in a consultative process, risk factors across the University had been identified. The risk factors included: the level of management commitment to administrative duties, recent changes in management and other key personnel, effectiveness of the unit's internal controls, complexity of the unit's operations, size of the unit's budget, liquidity of its assets, the impact of wrong-doing on the University's legal obligations and the integrity of its financial reporting, and the impact of the exposure of wrong-doing on the University's reputation. Those risk factors had then been ranked and weighted. The second step in updating the risk database would be the distribution to each of the over 300 budget units a self-assessment questionnaire to determine the level of each risk factor in the unit. The outcome would be an overall risk score for the unit. The revised database would then be used as a basis for the annual audit plan.

Mr. Britt said that in addition to using the database, the Internal Audit Department requested advice from the executive group and senior divisional management. Senior divisional leaders, such as the Deans of multi-department Faculties, were closest to the operations of the units and could often point out particular factors that would suggest that Internal Audit attention be given to a particular unit. Because of the Internal Audit Department's limited resources, the audit plan focused primarily on units with relatively high risk. A draft of the annual audit plan was distributed to the President and Vice-Presidents' group for discussion. The plan could then be revised to take into account suggestions from that group.

Mr. Britt continued that a risk-based approach was also used in the planning of each audit. At the planning stage, a detailed risk assessment was completed. This involved a review of the revenues and expenditures of the unit, its organization, its "hard controls" such as

segregation of duties and "soft controls" such as the skill and experience of key personnel. The outcome was the identification of critical areas on which to focus the audit. This approach was not in itself new, but the factors evaluated were now different and more valid in the current decentralized environment. Audits stressed procedural controls to manage risk and the matching of administration with objectives. This was a more forward-looking approach that provided a truer measure of the value of a unit's administrative work.

4. Internal Audit: Risk-Assessment Process in Preparing the Annual Audit Plan (Cont'd)

Mr. Britt noted that in addition to the emphasis on a risk-based audit approach, the Department was studying approaches used elsewhere. For example, some internal audit departments were adopting a process of unit self-assessment of controls based on information sessions and surveys. While Mr. Britt was not confident that such an approach would be appropriate at this University, he was keeping it in mind as a possibility.

The Chair thanked Mr. Britt. In view of the important role of the Internal Audit Department, it was important that the Committee understood its thought process.

Discussion focused on the following topics.

(a) Role of the President and Vice-Presidents with respect to the annual audit plan. The Chair asked whether the executive group had ever prevented or sought to dissuade the Internal Audit Department from undertaking any audit. Mr. Britt answered unequivocally in the negative. There had been no instance of interference. The discussion focused on anticipated changes and other developments in units and the consequent advisability of adding certain units to the audit plan. There had never been any effort to have a unit removed from the plan.

(b) External auditors' view. In response to the Chair's question, Mr. Bowman said that the evolution to a risk-based audit approach was, in his view, entirely appropriate.

5. Internal Audit: Semi-Annual Report - Interim Review of Audit Findings

Mr. Britt presented his semi-annual report. A substantial portion of the Department's efforts in the first quarter of the fiscal year had been devoted to assisting the external auditors with the year-end financial-statements audit. The Department had also assisted the external auditors with the enrolment audit and the audit of capital spending. In addition, over the past six months, the Department had devoted more time than originally intended to audits related to year-2000 preparedness. That work had taken most of the time of Mr. Moore and of one contract auditor. Departmental audits had included the Faculty of Dentistry, a large and complex unit with extensive research and clinical activity, and also the School of Continuing Studies and Woodsworth College, two units with highly distinctive functions within the University. The Department had maintained its continuous auditing program, auditing each month a sample of particular transactions where compliance with policies and procedures was, in the judgement of the Department, potentially troublesome. Apparent anomalies had been identified and followed up, and quarterly reports had been prepared and submitted to the President and Vice-Presidents. Four special reviews had been undertaken. Mr. Britt would make an *in camera* report on two of them later in the meeting. The Department had provided 107% of its budgeted audit hours because of the hard work of the Internal Audit staff. At this time, owing to the year-2000 work and owing to complexities in some of the larger audits, the Department was two departmental audits behind schedule. The Department had, atypically, remained at full complement during the year to date, and it had been assisted by contract auditors. The professional development of the staff had continued, with Mr. Moore having received the Certified Internal Auditor designation and Mr. Evan Apsit having received the Certified Management Accountant designation.

Highlights of Mr. Britt's observations and findings were as follows:

- **Accountability reports**. The Internal Audit Department took the matter of completion of accountability reports seriously in its audit process. A total of 162 reports should have been

5. **Internal Audit: Semi-Annual Report - Interim Review of Audit Findings** (Cont'd)

completed in units subject to audit in the six months ended October 31st, 1999. Of those, 25 or 15.4% had not been submitted. The large majority of those reports, 21 of the 25, should have been completed by administrative staff members. The reason for the failure to submit reports was in most cases the staff member's belief that she/he did not have "financial responsibility" and therefore was not required to complete such a report. Staff members and their supervisors often interpreted "financial responsibility" to mean budgetary authority. In fact, all staff members with the ability to make entries onto the Financial Information System and the Human Resources Information System were required to complete those reports.

- **Review by budget unit heads of financial reports produced by the Administrative Management Systems**. A unit head's failure to review monthly financial reports, including payroll-distribution reports, when combined with the absence of segregation of duties of the unit's business officer / administrative assistant, would cause a real risk that errors and improprieties would not be discovered. During the six months ended October 31st, 1999, the situation had improved, with the failure to review reports, combined with the absence of segregation of duties, occurring in only two of the nine departments audited. It appeared, therefore, that the message concerning the importance of regular review of reports was being received, although there were still pockets where this procedure was not being followed. Therefore, the Financial Services Department was developing five exceptions reports for budget unit heads. Those reports should be of real assistance to the unit heads, some of whom had said that they did not review the regular monthly reports because they found them cumbersome, not meaningful, or even impossible to understand.

- **Purchasing Policy compliance**. Some units had failed to obtain the required number of price quotations and had failed to issue purchase orders for purchases between $5,000 and $25,000. The requirements of the Purchasing Policy were often circumvented by splitting purchases from a single vendor into two or more orders, paid by invoice. To deal with this problem, the Controller had undertaken to review and follow up on all cases of multiple purchases from a single vendor. She would identify such cases through a monthly report produced by the Internal Audit Department.

  Mr. Britt noted that the Controller would be able to perform this function more satisfactorily than would the Internal Audit Department. The Controller would follow up diligently on all cases, whereas the Internal Audit Department would be able to work only on the basis of samples of cases.

- **Taxation of payments: employee / employer relationships**. The Department continued to find instances of payments to individuals, who should be regarded as employees, being made through invoices. As a result, there was no withholding of amounts for taxes, Canada Pension Plan and Employment Insurance premiums, etc. In some cases, agreements between the units and the service-providers were also not appropriately documented. As a result, the University faced the risk of liability for the amounts that should have been withheld, along with penalties and interest charges. This had been a long-standing

problem, but a significant first step was being taken. The Controller and Director of Financial Services was revising the *Taxation of Payments Manual* to assist unit heads in determining: (a) when payments could made be made to individuals by invoice for such services as consulting, and (b) when individuals should be regarded as employees. The revised manual would be released shortly.

5. **Internal Audit: Semi-Annual Report - Interim Review of Audit Findings** (Cont'd)

- **Year-2000 readiness**. As members knew, testing had revealed no significant problems in University-wide computer systems, and all divisional mission-critical systems, with two exceptions, were ready for the year 2000. In the two unready units, new software was being installed and tested, and the divisions expected it to be functioning before the end of the year. Contingency plans were in place in those two cases.

The Chair expressed real concern that the problems reported to the Committee on numerous occasions in the past were continuing to occur. In some ways, the situation appeared to be deteriorating. For example, the program of accountability reports represented an important initiative, but there had been an increase in the proportion of cases where the reports had not been submitted. The new exceptions reports, the revisions to the *Taxation of Payments Manual,* and the new monitoring of possibly split purchase orders all represented good initiatives, but the proportion of failures to comply with appropriate policies and procedures still remained too high. While it was probably not realistic to expect 100% compliance, the University should aim for that figure. Were there steps the Committee could take to make clear its expectations and to support the actions required to achieve those expectations?

Mr. White replied that the situation was not deteriorating but, on the contrary, improving significantly. The proportion of cases of failure of unit heads to review monthly financial reports had declined significantly. It was true that the proportion of cases of failure to complete accountability reports had increased somewhat, but those cases had consisted primarily of individuals with junior-level financial responsibility who were unaware that they were required to complete the reports. Mr. White was surprised at this absence of awareness. Guidelines had been widely issued and numerous seminars offered. But, the administration's focus in implementing the program of accountability reports had been on more senior levels of financial responsibility, and efforts would now be developed to ensure that more junior officers were made aware of their responsibility to complete the reports. Mr. White thought that the new program of accountability reports was a wonderful tool, helping managers to identify problems in their divisions' controls and to make progress in dealing with them. While the University was not yet where it should be, it was making progress. That progress would be assisted by the new exceptions reports, combined with the training and discussion that would go along with their roll-out.

Ms Brown said that extensive training programs on financial responsibilities were being provided to business officers, with courses taking place over several days and dealing with such topics as accountability and controls. A similar program was provided to staff members aspiring to advance into management positions. A member commented that he had found such programs to be useful only if the training was mandatory. Was attendance required at the programs Ms Brown had described? Ms Brown replied that attendance was voluntary. However, both programs had been offered for the first time and both had been seriously oversubscribed. Both would be repeated. Ms Brown noted that the programs were directed to diverse audiences. There were over 300 budget units, some very large and some very small. The level of financial expertise among staff members varied widely. In some multi-departmental divisions, a high level of expertise often existed at the divisional level.

Ms Brown commented on the new exceptions reports. Her department had just completed focus-group discussions of draft reports. Groups had included business officers and academic administrators. At least one financial representative from each Faculty or other division had been invited to comment on the reports. Several changes had resulted, and the programming of those changes was now underway. Ms Brown anticipated that the extensive consultation in the design of
the reports would help to foster acceptance of them. In December, there would be a formal

5. Internal Audit: Semi-Annual Report - Interim Review of Audit Findings (Cont'd)

announcement of the reports to the leadership of the University, along with instructions on how to access them.

The Chair acknowledged the progress that had been made in such areas as training, exceptions reports, and the revisions to the *Taxation of Payments Manual*. Without diminishing the credit due for all of the hard work and responsiveness that had brought about those improvements, he remained concerned about the significant number of recurring problems. He therefore urged continued diligence with the aim, however unachievable, of 100% compliance to University policies and procedures.

6. External Auditors' Letter arising from the 1999 Year-End Audit

Mr. Bowman said that the auditors had found no significant weaknesses in the University's internal controls that would create anything more than a low level of risk of material misstatement in the financial statements. The sole exception was the risk of impact of the year-2000 problem, and that situation appeared to be well in hand. Mr. Bowman expressed gratitude for the excellent cooperation provided throughout the external audit.

The Chair commended those in the University responsible for this outcome. That the external auditors had no recommendations did indicate that progress was being made with respect to internal controls.

7. External Auditors' Engagement Letter, 1998-99

Mr. Bowman said that the engagement letter remained largely unchanged from the previous year. Although the audit would be performed in the year 2000, the letter did retain a reference to year-2000 readiness. That paragraph was maintained because it was not possible to be sure that problems would not arise in the systems until some time well into the new year. While the engagement letter did not again list Ms Martha Tory as an advisory partner, she would be available as required.

The Chair referred to the comment on the year-2000 matter in the second full paragraph on page 2 of the engagement letter. The final sentence stated that the auditors "may communicate matters arising from the Year 2000 issue that come to our attention during our audit . . . ."
The Chair asked that the auditors definitively undertake to communicate any concerns that arise. Mr. Bowman undertook to do so.

8. External Audit: Review of Fees

Mr. White recalled that it was his usual practice to report to the Audit Committee each fall on the fees for the external audit for the forthcoming year and to provide comparative figures for the previous three years. The fee for the main audit would remain unchanged at $97,000 and the fee for the enrolment audit unchanged at $5,500. The report included, in accordance with the

usual practice, the survey of audit fees compiled by the Council of Financial Officers of the Universities of Ontario (COFO-U.O.) Mr. White noted that the fees paid by the University of Toronto compared well against those paid by other Ontario universities, all of them smaller than the University of Toronto. Also provided were the fees for other University of Toronto audits such as the capital projects audit, the Ontario Student Opportunity Trust Fund (O.S.O.T.F.) audit and the audits for Hart House and the University of Toronto Press. The report also listed special assignments other than audits carried out for the University by Ernst & Young. The objective of that information was to enable the Committee to satisfy itself that this additional work was not of

8. External Audit: Review of Fees (Cont'd)

such a scope as to compromise the independence of the external audits.

Mr. White referred to the $68,000 fee charged for advice concerning recoveries of payments for the Goods and Services Tax (G.S.T.) While this fee was large, the work by the tax specialists at Ernst & Young had led to the recovery of a large amount of G.S.T. payments. Ms Brown elaborated. The firm had carried out a review of how various departments handled payments of the G.S.T. The outcome had been a significant recovery of unnecessary payments. The fee paid to Ernst & Young was a contingency fee, representing a small proportion of the tax recovered. Owing to a confidentiality agreement, Ms Brown was not free to disclose the specific items of advice that had led to the recoveries. She reported that the Ontario Universities Purchasing Managers had also undertaken an initiative. That group had, after a competitive process, hired the firm of Deloitte and Touche to determine whether tax savings could be found for the Ontario universities. That firm's staff was currently on site. In response to a question, Ms Brown said that the University was required to pay sales taxes and import duties. The University was able to claim rebates on two thirds of its payments for the Goods and Services Tax, and it enjoyed an exemption from Provincial Sales Tax on goods purchased exclusively for research.

Referring to the COFO - U.O. study, a member noted that the $29,500 fee paid by the University of Toronto for capital projects audits in 1997-98, the most recent year of the survey, had been exceptionally high. On the other hand, the fee paid for the enrolment audit had been exceptionally low. Mr. Britt responded that the low fee for the enrolment audit arose from the assistance provided by the Internal Audit Department to the external auditors. In the case of the audit of capital spending in 1997-98, the large fee had been an aberration caused in part by the need to complete somewhat more audit work than usual owing to certain complications and by the fact that the Internal Audit Department had not had the resources available to assist the external auditors with that additional work.

The Chair recalled the provision in the Purchasing Policy for a review of professional services at least every five years. Mr. White said that external audit services had been reviewed three years ago. One outcome had been a significant reduction in fees amounting to between 10% and 15%. That reduction had followed an earlier reduction some five or six years previously.
Mr. White had concluded that there was now not a great deal of opportunity to request further reductions in the fee without endangering the quality of the audit. A member asked whether the reduction of fees had been accompanied by any reduction in the scope of the audit. Mr. White stated that there had been no reduction whatever in scope. The University had agreed to prepare certain information required by the auditors, relieving them of some time requirement, and the University had also agreed to accept a lesser level of backup material. For example, the auditors no longer prepared a detailed written report on their audit plan. While eliminating costs in that way, the University and the auditors had been able to reduce the cost of the audit without any reduction in its scope or quality.

The Chair asked whether the University planned to call for tenders for the audit sometime in the next two years. Mr. White replied that he would call for tenders only if he foresaw any need to change the audit firm. He would wish to change auditors only if there was reason for dissatisfaction with the auditors' services. It would be highly onerous to bring in an entirely new team of auditors who were wholly unfamiliar with the University's operations. This would require a great deal of time by University staff to orient the auditors and to provide information for them. Rather, the University sought renewal by periodic changes in the audit partner. The auditors themselves would make periodic changes in the audit manager and other staff. This would allow
for an appropriate balance between continuity and renewal. It would be wrong to call for tenders for the audit only to seek savings. While a firm might well capture the assignment by a low bid for

8. External Audit: Review of Fees (Cont'd)

the first year, the cost in terms of University staff time would be great and the cost of the audit itself would soon rise to the previous level. A member agreed with this approach. He noted that the requirement in the U.S. was that the audit partner change at least every seven years.

9. Report of the Administration

Internal Audit: Special Reviews

On motion duly made and seconded, it was RESOLVED THAT the Committee move *in camera*.

Mr. Britt reported on his Department's special reviews.

On motion duly made and seconded, it was RESOLVED THAT the Committee conclude the *in camera* session.

During the *in camera* session, Mr. Britt reported on four special reviews. In two cases, the Department had concluded that improprieties had taken place.

In one case, certain University assets had been found to be missing. It was learned that a staff member had without permission removed those assets for use at home, probably intending eventually to return them. That intention had not been carried out owing to the staff member's unexpected death. As a result of the audit, the assets had been recovered.

In a second case, a member of the faculty holding a research grant had, without disclosure and contrary to the *Policy on Conflict of Interest*, engaged a company owned by an immediate family member to provide certain services. There was reason to doubt that the company was a going concern and, while there was no conclusive evidence, there was also doubt that the services had in fact been rendered. The University had disclosed the result of the audit to the granting council and had repaid the amount of the grant. As the result of this matter, the individual was no longer an employee of the University. The Internal Audit Department had also undertaken additional special auditing with respect to other grants provided by the same granting council, finding no significant misuse of funds.

10. Dates of Next Meetings

The Chair noted that the next meeting date was a reserve date - **Wednesday, March 15th, 2000 at 5:00 p.m**. Two members suggested that it would be worthwhile to consider another orientation session like that presented the previous year. Such an orientation should concentrate on the University's broader financial picture, to give members a better view of the "forest" rather than the "trees" viewed in regular meetings. The orientation could also discuss key areas of financial risk. The Chair commented that this might well be a useful use of the reserve date, along with any other business that would require the Committee's attention.

REPORT NUMBER 55 OF THE AUDIT COMMITTEE - November 24th, 1999

The Chair reminded members that the next regular meeting after the reserve date was scheduled for **Wednesday, May 24th, 2000 at 5:00 p.m**.

The meeting adjourned at 8:10 p.m.

	____________________	____________________
	Secretary	Chair
January 17th, 2000		