UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 60 OF THE AUDIT COMMITTEE

May 23, 2001

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, May 23, 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
Ms Kwai Li
Mr. Paul E. Lindblad
Mr. Richard Nunn
Mr. Roger P. Parkinson
Professor Wally Smieliauskas

Ms Sheila Brown, Acting Chief Financial Officer***
Mr. Louis R. Charpentier, Secretary of the Governing Council***
Mr. Mark L. Britt, Director, Internal Audit Department

Secretariat:

Mr. Neil Dobbs***
Ms Beverley Stefureak***

In Attendance:

Mr. Gerald A. Lokash, member, Governing Council and Business Board
Mr. Keith B. Bowman, Ernst & Young***
Ms Diana Brouwer, Ernst & Young***
Mr. Donald W. Lindsey, President and Chief Executive Officer, University of Toronto Asset Management Corporation*
Ms Tiffany Palmer, Manager, Compliance and Reporting, University of Toronto Asset Management Corporation**
Mr. Pierre Piché, Acting Controller and Director of Financial Services***
Ms Deborah E. Simon-Edwards, Executive Assistant to the Chief Financial Officer***
Ms Julianna Varpalotai-Xavier, Director of Finance and Administration, University of Toronto Asset Management Corporation**

* In attendance for items 2, 3 and 4.
** In attendance for items 2 and 3.
*** Absented themselves for the consideration of item 8.

ITEM 2 CONTAINS A RECOMMENDATION TO THE BUSINESS BOARD FOR ACCEPTANCE

REPORT NUMBER 60 OF THE AUDIT COMMITTEE - May 23, 2001

1. Report of the Previous Meeting: Report Number 59 - November 15, 2000

The Chair noted that a corrected version of the report of the previous meeting was included in members' agenda packages. It contained two corrections. In the penultimate paragraph on page 4, the total of royalties and equity transferred from the Innovations Foundation to the University's inventors was $4.2-million, rather than $7.3-million. On page 13, the name of the University's student records system was corrected to Repository of Student Information, not Student Records, hence the acronym ROSI. Report Number 59 (November 15, 2000), as corrected, was approved.

2. University of Toronto Asset Management Corporation: Financial Statements, 2000

The Chair noted that the University of Toronto Asset Management Corporation (UTAM) was classified as an "incorporated business ancillary operation." The Audit Committee was asked to consider UTAM's financial statements and, if appropriate, recommend them to the Business Board for acceptance. Unlike the other ancillary operations, the Business Board had received directly the remainder of UTAM's annual report. Before the establishment of a separate investment-management corporation, the Business Board had reviewed an annual report on investments and, given the stakes involved, wished to continue to receive that report directly. The Audit Committee's role, therefore, was a limited one, but an important one: to be satisfied with the financial statements and to be satisfied with the controls over the invested assets - the subject of the next agenda item.

Ms Brown said that the statements covered only a partial year, from UTAM's start-up on May 1, 2000 to the end of its fiscal year on December 31, 2000. The balance sheet contained only UTAM's own assets and not the assets that UTAM invested for the University and the pension plans. UTAM's statements were consolidated into those of the University.

Ms Varpalotai-Xavier said that the financial statements had been reviewed by UTAM's Audit and Compliance Committee and approved by its Board. Three pages containing miscellaneous information had been listed in the table of contents but not distributed to members. Copies of those pages had been placed on the table for the meeting. Those pages provided information breaking down operating costs and listing UTAM's Board membership and staff.

On the recommendation of the Acting Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

THAT the audited financial statements of the University of Toronto Asset Management Corporation, December 31, 2000, a copy of which is attached hereto as Appendix "A", be accepted.

3. University of Toronto Asset Management Corporation: Controls over Investment Assets

Ms Varpalotai-Xavier and Ms Palmer described UTAM's controls over the University's and the pension plans' investment assets.

- **UTAM Audit and Compliance Committee: Terms of Reference.** The Audit and Compliance Committee would play an oversight role with regard to: the integrity and fair presentation of financial statements and reports on investment performance and risk; the system of internal and external controls over the investments; compliance with applicable laws and regulations and the maintenance of proper standards of conduct; and compliance with the University's investment policies. The Committee consisted of three Directors, appointed by the Board. The University's Chief Financial Officer also participated in some of the Committee's meetings. The Committee was required to meet at least twice a year, and special meetings could be called at the request of the Chair or any other Committee member, the external auditors, the University's internal auditor, or UTAM management. The Committee had in fact already met four times and would likely meet quarterly until risk-control and financial reporting procedures were well established. The Committee was responsible for reviewing the financial statements and other financial information; recommending the appointment of the external auditors and meeting regularly with the external and internal auditors; ensuring the adequacy of accounting systems and controls; and ensuring the adequacy of corporate governance and compliance.

- **UTAM Audit and Compliance Committee: Work to date.** At a planning meeting, preliminary work had been done on a number of matters including: means of UTAM's accountability to the University; Audit and Compliance Committee Terms of Reference; the Committee's calendar of business; the UTAM Conflict of Interest Policy and Code of Ethics; means of ensuring compliance by the external portfolio managers and the custodians; the external auditors' engagement letter; the role of the University's Internal Audit Department; and risk-management procedures.

  At the Committee's first four meetings, it had reviewed, approved or, in appropriate cases, recommended to the Board: its Terms of Reference; Ernst & Young's engagement letter; the Committee's calendar of business; the external audit fee; the general role of the University's Internal Audit Department; external agencies' responsibilities with respect to UTAM; the audited financial statements for the year ended December 31, 2000; a Corporate Governance Policy, Proxy Voting Guidelines and related documents; an Operational Due Diligence Checklist; a preliminary list of policies and procedures to be developed; an update on the State Street Automated Compliance Project; and UTAM's internal operating results for the first quarter of 2001.

- **UTAM Audit and Compliance Committee: Work planned**. An August meeting would: review the external auditors' management letter; hold separate private meetings with the internal auditors and the external auditors (with no staff present); recommend the appointment of external auditors for 2001 (a pro forma recommendation because UTAM had agreed to engage the same auditors as the University); and consider the detailed

3. <u>University of Toronto Asset Management Corporation: Controls over Investment Assets</u> (Cont'd)

arrangements for the role of the University's internal auditor. A meeting in November would, on the basis of eighteen months' experience, review the Committee's terms of reference and would also review the external audit plan and fees.

- **Compliance: Responsibility**. All UTAM staff were regarded as being responsible for ensuring compliance with the relevant laws, policies and practices. UTAM promoted a company-wide, self-regulatory attitude towards compliance and ethics. It had adopted the Professional Conduct Program of the Association for Investment Management and Research (AIMR), and all staff were expected to adhere to the AIMR Code of Ethics, its Standards of Professional Conduct, and its Professional Conduct Statement. The Manager, Compliance and Reporting, reported to the Director, Finance and Administration but was accountable to the President and CEO, and to the Audit and Compliance Committee.

- **UTAM Internal Policies and Procedures**. To ensure the attainment of clear and concise controls, UTAM was documenting its internal policies and procedures. It would adopt new policies & procedures in response to industry changes and recommendations.

  Administrative policies and procedures dealt with the management of UTAM's own operations and included such matters as: personnel policies, payroll, personnel access, expenses, invoice payment and verification, server maintenance, electronic communication and travel and entertainment.

  Business Processing Policies and Procedures dealt with the day-to-day processing operations. Those polices and procedures covered such topics as: completion of manager contracts, new account set-up, cash-flow requirements, fund restructuring and rebalancing, paying management fees, handling special donations, auditing and reporting, and reconciliation of portfolio-manager and custodian account statements.

  General Control Policies and Procedures were designed to reduce internal risk exposure. They dealt with: signing authority, dual controls, segregation of duties, safekeeping, protection of confidential information, conflict of interest in personal trading, discrimination and harassment, and consequences of violations of policies.

  A draft list of all policies and procedures to be documented had been reviewed by the UTAM Audit and Compliance Committee in May, and, where policies and procedures were not already in place, all documentation would be completed by year-end 2001. Wherever it made sense, UTAM would adopt the University's policies and procedures.

- **Corporate Governance and Proxy Voting Guidelines**. The objectives of the Corporate Governance Guidelines were to acknowledge UTAM's responsibility with respect to the governance of the corporations in which investments were made and to recognize that the right to vote was one of the most effective tools of corporate governance. UTAM used

3. **University of Toronto Asset Management Corporation: Controls over Investment Assets** (Cont'd)

proxies to exercise the right to vote the University's and the pension plans' shares. Because UTAM most often used external managers, it delegated voting authority to them, but it provided a set of proxy voting guidelines to provide a framework to guide the managers in casting those votes.

With respect to the administration of proxy voting, UTAM insisted that its managers use the best practices to ensure: the timely receipt and processing of proxies; the actual voting of those proxies; and record-keeping of proxy materials. To ensure that best practices were used by the external managers, UTAM had developed a Proxy Voting Due Diligence Checklist, which UTAM would use in connection with manager visits.

The Corporate Governance and Proxy Voting Guidelines, and the Proxy Voting Due Diligence Checklist, had been approved by the UTAM Audit and Compliance Committee on May 9, 2001, subject to minor changes. When those changes were drafted, the Proxy Voting Guidelines would be sent to the external managers. UTAM would then carry out on-going monitoring of adherence to the Guidelines by requiring the managers to submit an annual proxy voting report and by an annual due-diligence visit to each manager.

- **External investment managers' operational controls**. UTAM had developed an "Operational Due Diligence Checklist" to ensure that the external portfolio managers had strong procedures and controls to safeguard University and pension-fund assets. The objective was to control "operational risk" which was defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events." (That contrasted with investment risk, which was monitored by UTAM's Managing Directors.) The checklist followed an audit approach that encouraged self-assessment by the investment managers themselves.

  The first step was to be completed by UTAM staff before making their site visit. The objective of that step was to assess the manager's operational risk management program by: obtaining and reviewing the manager's operational risk-management policy documents; determining who was responsible for ensuring that operational risk was addressed; determining the role of the investment manager's compliance function and its internal audit function; and carrying out an analysis of the quality of the manager's operational risk controls. After inspecting the documentation submitted by the external manager, UTAM staff would make any enquiries necessary to clarify the manager's operational risk-control procedures.

  The next step would be to observe the manager's actual performance of controls at an on-site audit. The objective was to test for not only the existence but also the effectiveness of the controls. UTAM staff would observe trading procedures from start to finish. Were securities trades: valid? properly authorized? appropriately allocated among accounts? priced correctly? settled and reported on time? Were there any trading violations such

3. **University of Toronto Asset Management Corporation: Controls over Investment Assets** (Cont'd)

as front-running, insider trading, high-close transactions, or unauthorized cross-trading? Were there controls to prevent soft-dollar practices that would not serve client interests? Was there a strong, enforced policy to prevent conflicts of interest arising from personal trading? Were there appropriate general financial controls: segregation of incompatible duties? dual controls? Was the firm undergoing any regulatory investigations?

Following the on-site audit, UTAM staff would write a comprehensive report and carry out on-going monitoring of any identified risk or problem areas.

Upon making the changes to the policy, guidelines and checklist arising from the May 9 Audit and Compliance Committee meeting, UTAM would begin the on-site visits to the external managers with a view to visiting all of them by year-end 2001.

- **State Street Compliance-Reporting System**. This automated risk-management tool would monitor the funds' adherence to various investment restrictions contained in legislation (e.g. Pension Benefits Act and the Income Tax Act) and in the University's investment policies. The automated testing would be customized to test for adherence to the University Funds Investment Policy and the Pension Fund Master Trust Investment Policy and its future amendments. Monthly reports would verify compliance with various provisions (for example the limit of foreign exposure in the pension fund), would provide warnings where the funds were near the compliance limits or would advise of non-compliance. This would allow for the prompt resolution of issues with the external investment managers before UTAM actually violated any legal or policy requirements.

  UTAM and the State Street Compliance group were making very good progress at implementing this system. Tests had been set-up to reflect the University policies and the Pension Benefits Act restrictions. UTAM was working intensively with State Street and it was anticipated that the automated system would be in place within days to test the April 2001 data.

- **Pricing of assets**. The University's Audit Committee had enquired about pricing of assets. The pricing of liquid assets - publicly traded securities and security-index futures - was relatively straightforward. If the prices reported by the external portfolio managers departed past a tolerance level from the closing prices provided by such sources as Reuters or Bloomberg, the custodian (State Street) would investigate.

  It was, however, also necessary to price investments that did not trade on the public markets, specifically, private-equity investments made through limited-partnership vehicles. The private offering memorandum and limited-partnership agreement for each partnership described the valuation policy, which followed industry standards in all cases. The limited-partnership units were valued at cost or fair market value based on all pertinent facts. Those pertinent facts included: arms-length, third-party transactions in

3. <u>University of Toronto Asset Management Corporation: Controls over Investment Assets</u> (Cont'd)

comparable securities; discounted-cash-flow analyses; significant events affecting the issuer; and the restrictions on sale or transfer. The value of the investment would be written down at once, if necessary below cost, by the general partner in the event of any significant impairment in the value of one or more of the limited partnership's investments. The value of the investments would not be increased for a few years until these relatively new limited partnerships were fully invested, i.e. until all of the money committed by all of the partners was fully used in the partnerships' investments. Even then, there was a considerable time lag in valuing those investments. They were at best valued quarterly, and the valuations often took six to eight weeks to complete after the quarter end.

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

(a) Investment managers under investigation by regulatory authorities. A member asked why UTAM would continue to deal with any external investment manager who was under regulatory investigation. Mr. Lindsey and Ms Palmer replied that some investigations were simply regular due-diligence audits that did not imply any suspicion of misbehaviour. In other cases, investigations could be undertaken in response to complaints, but the matter might be so limited as not to impair the on-going value of the firm's management. If, however, any firm was engaging in fraudulent practices, UTAM would not hire the firm or would terminate an already engaged firm.

(b) Timing of the assessment of the external investment managers' operational controls. In response to a question, Mr. Lindsey said that the focus of this presentation had been on assessing the operational management controls of current managers, but as UTAM proceeded to consider new managers, the operational-control assessment would be carried out before engaging the manager.

(c) Private-equity investments. In response to a member's question, Mr. Lindsey said that UTAM had developed a number of criteria by which it evaluated all private-equity investment proposals. It made all private-equity investments through limited partnership vehicles managed by external fund managers, who were the general partners. UTAM had invested in some early-stage ventures and in a buyout fund that concentrated on more mature businesses that required infusions of capital. It might invest in real estate but had not done so to date. There were no geographical limits. The first three private-equity funds in which UTAM had invested were located in the U.S. and the fourth was based in Canada. It was entirely possible that future ventures could include funds based in Europe. The only area where UTAM would not consider investments was U.S. real estate, where tax laws currently made such investments unattractive for institutional investors. The majority of the investments made by the limited partnerships would be at the stage of having cash flow. Some might be early-stage companies, with initial public offerings of their shares pending in twelve to eighteen months.

3. <u>University of Toronto Asset Management Corporation: Controls over Investment Assets</u> (Cont'd)

(d) Accountability reports. A member asked whether there was a process in place by which all UTAM staff signed statements annually that they were carrying out their responsibilities fully in compliance with all appropriate policies and procedures and that they were not aware of any non-compliance by others. Mr. Lindsey and Ms Varpalotai-Xavier replied that such an annual sign-off procedure would be put into place to the full satisfaction of the UTAM Audit and Compliance Committee. The Chair commended the University's annual accountability report process as a best practice and suggested that UTAM look at those reports as a model that could be adapted and adopted for senior staff.

(e) Staff complement responsible for compliance. In response to a member's question, Mr. Lindsey said that operational risk-control was handled by Ms Varpalotai-Xavier (as a part of her duties), Ms Palmer and one analyst. Operational risk controls were, in Mr. Lindsey's view, the most difficult controls to carry out because of the need to review a great deal of information and make judgements based on that information. Investment risk-controls were more straightforward, implemented by the analysis of quantitative data, ensuring, for example, that the investment in any individual security did not exceed the policy limit. The investment risk-controls were handled by UTAM's four Managing Directors, responsible for (i) North American equities, (ii) international equities, (iii) private-equity investments, and (iv) asset-allocation and special asset classes. The latter Managing Director managed risk-control for fixed-income investments and foreign currency exposures. The Managing Directors would ensure that the external investment managers' regular reports were congruent with those of the custodian or would ensure appropriate reconciliation. They would ensure that the portfolios of the external managers were consistent with the University's investment policies and the managers' mandates, and they would analyze the performance of the external managers. As specialists, they would be able to delve deeply into the work of the external managers and would be able to find signs of any problems at an early stage.

(f) Role of the external auditors. A member asked if the external auditors were involved in the assessment of UTAM's risk controls. Mr. Bowman said that the management letter arising from the 2000 audit had been completed. It reported that the external auditors had observed no operational weaknesses. They had received the full co-operation of UTAM management and staff. UTAM was in the process of planning a very complete control system. A member requested that when the University's financial statements were presented to the Committee in June, the external auditors comment on their approach to auditing the invested assets and to determining the fairness of their valuation.

(g) UTAM's control system relative to other institutional investment management corporations. In response to a member's question, Mr. Lindsey said that the risk controls being developed by UTAM were typical of those used by investment-management corporations at major U.S. universities or by such Canadian operations as the Ontario Teachers' Pension Fund (Teachers') or the Ontario Municipal Employees' Retirement System (OMERS), except that UTAM was developing its system from the ground up. UTAM staff had considerable experience

3. University of Toronto Asset Management Corporation: Controls over Investment Assets (Cont'd)

and was well versed in industry standards. In addition, Ms Palmer had consulted with the Teachers' fund and OMERS in order to take advantage of their experience and expertise. Those funds had been particularly helpful to UTAM in drawing up its proxy voting guidelines.

The Chair noted thanked Mr. Lindsey and his colleagues for their good work and their comprehensive presentation. He said that because UTAM was a separate corporation with its own Board and Audit and Compliance Committee, there was no need for the University's Audit Committee to become as deeply involved. The responsibility of the University Committee was to satisfy itself that appropriate structures and processes were in place for the safeguarding of the significant University assets in UTAM's charge. It appeared that UTAM was well on the way to establishing a comprehensive risk-control program and was very aware of the components needed for a successful program.

4. Financial Statements: Draft Notes

The Chair recalled that the Committee had for many years followed the practice of reviewing a draft of the notes to the financial statements at the meeting preceding that at which the statements as a whole would be presented. Ms Brown said that the Committee had before it the draft text of the notes as well as the comparative numbers from 1999-2000. Relatively few changes had been made to the notes, apart from those required to implement the new rules, put into place by the Canadian Institute of Chartered Accountants, for accounting for employee future benefits. The Committee had in November received a presentation on the University's proposal to implement the new rules and had had an extensive discussion of the matter.

Mr. Piché reviewed the changes to the financial statements from the previous year.

- **Note 1(d), Employee benefit plans** explained the implementation of the new accounting rules. In response to a member's question, Mr. Piché said that the University would amortize the change in the cost of employee future benefits arising from the new accounting treatment over fourteen years because that was the average remaining service projected for the University's employees.

- **Note 3, Investments**. The note included a number of new asset categories included in the University's investments.

  In response to a member's question, Mr. Lindsey said that a substantial proportion of the University's equity investments were in shares of companies located outside of Canada, resulting in considerable exposure to foreign currencies. One half of all foreign investments were hedged back to the Canadian dollar. The University used an external manager for this currency overlay program. The hedging program, which had been initiated in January 2001, was intended to control volatility risk arising from foreign currency exposure and had succeeded in doing so. All returns were converted to

4. Financial Statements: Draft Notes (Cont'd)

Canadian dollar terms and the value of the assets would be translated to Canadian dollars as at the University's April 30 year end. It was suggested that the notes should: (i) disclose the amount of the assets in foreign currencies, (ii) report the hedging policy, and (iii) state the accounting policy for translating the value of the foreign assets into Canadian dollar terms.

It was suggested that note 3(b), derivative financial instruments, should report the use of forwards for purposes of currency hedging.

In response to a member's question, Mr. Lindsey said that all derivative instruments used for investment purposes* were exchange-traded derivatives. The counter-party was, in effect, the exchange itself, with an AAA credit rating. The reference in the note to interest-rate swap agreements referred to agreements that the University itself had used in connection with its borrowing to finance certain capital projects such as student residence buildings. Individual swap agreements were not used for investment purposes.

During the discussion, members suggested a number of detailed editorial amendments, and Ms Brown invited members to let her know of other editorial suggestions as soon as possible.

5. Internal Audit: Annual Report, 2000-01

The Chair said that the Annual Report of the Internal Audit Department was presented for information. While no motion to accept the report was required, the Committee should make known any concerns, tender any advice, or request a follow-up report(s) if appropriate.

Mr. Britt presented his annual report.

- **Audit hours**. The Department completed 8,660 direct audit hours, less than the planned 9,500 hours. The negative variance had been caused by the time required to fill a position that had become vacant was well as by health-related leaves taken by two senior auditors. The result had been a loss of 1,100 hours.

- **Audit reports**. The Department had issued 32 reports: 19 departmental audits, 5 reports on the continuous auditing program, and 8 reports on special and other reviews.

- **Other audit activities**. In addition to the audits leading to reports, 15 follow-up reviews had been completed. In addition, assistance had been provided to the external auditors for the year-end audit of the financial statements, the enrolment audit, and the Government-mandated audit of the University's administration of the Ontario Student Assistance Program (OSAP).

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* This contrasts with the derivative instruments used for currency-hedging purposes, which were forward contracts.

5. **Internal Audit: Annual Report, 2000-01** (Cont'd)

- **Variance from plan**. Thirteen departmental audits from the 2000-01 audit plan had not been started, primarily because of the loss of staff time. In addition, the Department had incurred 550 additional hours assisting the external auditors with the new OSAP audit requirements. Finally, the Department had required 1,130 more hours than planned for the 22 audits undertaken. Of those 22 audits, 15 final reports had been issued, 4 reports were in draft form, and 3 were in progress. The audits that had not been started were carried forward to the 2002 audit plan.

- **Continuous Auditing**. The 2001 plan had included 1100 hours for completion of the remaining two quarters of fiscal 2000, the two quarters of fiscal 2001, and one quarter remaining in progress at April 30, 2001. The actual time used had exceeded that planned by 570 hours because the Department had substantially completed the audits of five quarters rather than four. The audit that was in progress as at April 30, 2001, was largely complete.

- **Special Reviews**. The time required for special reviews had exceeded budget by 384 hours. Special Reviews included requests from senior management for operational reviews, the annual student societies report, investigation of allegations of financial impropriety, and requests from administrative staff for assistance with solving problems or providing advice. Seven new special reviews had been undertaken in the year. Four were operational reviews that had been requested, and three had related to allegations of financial impropriety. Special reviews arose unexpectedly, and it was difficult to determine how long each review would take.

- **Department activities other than audits**. The department participated in presentations to various administrative groups about effective financial management, controls, and fraud awareness and prevention. Other staff activities included a review of the donations-management function and consulting work with the Council of Ontario Universities (C.O.U.) regarding the new OSAP Bursary and Scholarship Audit Guidelines.

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- **Audit Effectiveness Questionnaire**. The Department used a questionnaire to obtain feedback from units that had been audited about their satisfaction with the internal audit process. Mr. Britt was very pleased to report that the responses indicated that the units were, overall, satisfied with the audit process, and they thought that the audits had added value.

Mr. Britt briefed the Committee on his general audit observations and provided his overall assessment of internal controls. Mr. Britt thanked his colleagues in the Internal Audit Department for their fine work, praising their efforts in dealing with sometimes complex and challenging audits with professionalism and integrity. He also thanked the officers of the divisional, central and senior administration for their support and diligence in addressing the recommendations included in the audit reports. Ms Brown responded to Mr. Britt's observations and assessment. She thanked Mr. Britt and his colleagues for their work, which was of great

5. <u>Internal Audit: Annual Report, 2000-01</u> (Cont'd)

value to the central administration, helping them to zero in on problem areas and problem departments. It was also very useful to be able to call on Mr. Britt for assistance in dealing with particular problems, which he and his colleagues would provide in addition to their usual program of reviews. Deans and other budget-unit heads also made use of Internal Audit's willingness to assist in looking into problems that arose from time to time. The valuable contribution of the Internal Audit Department was widely recognized.

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

(a) Computer-assisted auditing techniques. A member asked whether the Internal Audit Department used computer-assisted auditing techniques. The Department might, for example, be able to find instances of improper payments or consulting payments to employees by comparing postal codes of employees and payment recipients. Mr. Britt replied that the Department routinely used computer-assisted techniques. It was, however, not possible to rely wholly on computer-assisted checks because of inconsistencies in the way in which information was recorded on the system. There was, for example, no standard way of entering Post Office boxes. Therefore, computer checks could not be relied upon to identify two payments to a single address.

(b) Co-operative purchasing arrangements. A member asked whether the University participated with other institutions in group purchasing arrangements to negotiate the best possible price for high-volume purchases. Mr. Britt replied that such arrangements were in effect for a number of commodities including natural gas and paper. In some cases, the University participated in purchase arrangements for public-sector institutions coordinated by the Province of Ontario.

(c) Outcome of individual departmental audits. A member commented that he was used to seeing internal audit reports in a standard format that included ratings indicating: (i) whether the department's operations were better than the norm, at the norm, or in need of improvement to reach the norm and (ii) whether the department's operations were improving or deteriorating from previous years. Mr. Britt replied that because of the heterogeneity of the University there was no formal system. Many departments were in a unique situation, and the staff of various departments had varying levels of skill. It would, therefore, not be useful to compare and rank departments. Mr. Britt was frequently asked by departments how they compared with others. His response was to comment on the audit findings the department shared with others and those that were unique. He would also comment on relative levels of risk, and he would compare the department's findings with those from a previous audit to illustrate improvement or the lack of it.

(d) Information system audits. A member observed that the Department had used less than 100 of the 500 hours budgeted for reviews of information systems. Mr. Britt replied that the there had been no major enhancements to the Administrative Management Systems during the 2000-01 year. The planned addition of the position-management module had not proceeded. Therefore, only more routine reviews were required. In response to a question, Mr. Britt said that the category did not involve reviews of local area networks.

5. **Internal Audit: Annual Report, 2000-01** (Cont'd)

(e) Follow-up reviews. In response to a member's questions, Mr. Britt said that the follow-up review process began nine to twelve months after the issue of the initial audit report. The first step was a self-assessment questionnaire, asking the department whether the recommended remedial steps had been taken. The response was then evaluated, and an on-site visit was carried out to ensure that the steps had in fact been implemented. The follow-up process would include the review of the Procurement Services Department.

In the course of the discussion, the Chair, on behalf of the Committee, thanked Mr. Britt for his thorough report and congratulated him on receipt of the internal auditing specialist designation from the Canadian Institute of Chartered Accountants. He also thanked Ms Brown for her complete response to the report and congratulated her and her colleagues for their achievements in the area of internal controls: the new exception reports generated by the Financial Information System, the continuing and improving educational programs, the improvements in the return rate for the accountability reports, and the other steps that had been taken.

The Chair nonetheless expressed his concern about a continuing, significant level of non-compliance with University policies and procedures. The continuing non-compliance with the requirements of the Purchasing Policy and the weaknesses of the vendor-management program were two examples. Even after several years, a significant portion of accountability reports were not being submitted by individuals with financial responsibility. While the central administration had continued to generate good ideas and put into place good programs and educational initiatives, they had not been sufficient to ensure the very high level of stewardship of resources to be expected in a leading public institution. The problem appeared to be the absence of consequences for failure to comply. While the Chair was heartened by the internal auditor's conclusion that "the current year's audits did not identify significant errors or losses occurring from the existence of the above-noted risks," it was important that the Audit Committee deliver a strong message about the need for consequences to ensure compliance with policies and procedures.

With respect to accountability reports, Ms Brown said that the University's administrators did understand the need for the reports. The reports that were not completed were most frequently from principal investigators and from junior staff reporting to business officers who thought that only their superiors were required to complete the reports. The approach taken by the central administration was to demonstrate, for example to department chairs, that it was in their interest to ensure a full return of reports from their staff. If the chair signed an accountability report and a junior staff member did not, that implied that the chair was taking responsibility for the actions of the staff member, leaving the chair unprotected. The administration attempted to operate on the basis of an alignment of interest. In more general terms, the administration stressed the importance of demonstrating to governments and benefactors that the University was well managed to ensure that it continued to receive the means

5. <u>Internal Audit: Annual Report, 2000-01</u> (Cont'd)

to carry out its academic mission. Ms Brown stressed that the views of the Audit Committee were well known and appreciated as the administration sought to carry the message to all parts of the University.

6. <u>Internal Audit: Audit Plan, 2001-02</u>

Mr. Britt presented the Internal Audit Plan for 2001-02. The plan budgeted for 9,100 hours, a reduction from 9,500 hours the previous year. While the Department's complement remained at eight, the reduction was necessary to take into account (a) the University's changed vacation entitlement for staff below the management level, and (b) vacation entitlement carried forward by some staff from the previous year. The plan made provision for 22 departmental audits as well as time for the continuous auditing of selected transactions in all departments. In addition the plan included 900 hours to assist the external auditors with the financial statements audit, time for special reviews, information-systems reviews and follow-up reviews. The selection of departments for audits was based on the Internal Audit Risk-Assessment Database. The 16 units classified as high risk would be audited at least every four years, the 131 categorized as moderate risk at least every eight years and the 146 units classified as low-risk would be visited on a discretionary basis. All areas, and especially the low-risk areas that would receive less frequent departmental reviews, would be looked at with special care as part of the continuous auditing process. The thirteen departments selected for 2000-01 that were not reviewed were carried forward onto the 2001-02 list. Four of those departments were classified as low risk, but planning work had been completed for them, and it would be inefficient not to proceed with the audits.

Discussion focused on the following matters.

(a) Follow-up reviews. A member observed that the budget for follow up reviews had been reduced substantially.

(b) Risk-based audit approach: division of time among risk categories. Two members asked whether it would be more efficient to focus more of the limited number of audit hours on the areas classified as high risk. Mr. Britt replied that it was important that the Internal Audit Department's work cover, and be seen to cover, all departments on all three campuses. It would not be possible to achieve that outcome by concentrating solely on the sixteen high-risk units. Rather, the Department sought optimal use of its time by concentrating on the high-risk areas while still selecting from amongst the moderate- and low-risk units.

(c) Risk-based audit approach: criteria. In response to a member's question, Mr. Britt said that the identification of risk in a unit was based on judgements involving the following criteria: management's integrity and commitment; any recent change in key personnel; effectiveness of internal controls; complexity of operations; the size of the unit's operating and restricted-funds budgets; the liquidity of its assets; the extent and impact of external exposure, including the importance of the unit's activities for legal and regulatory compliance and financial reporting and

6. Internal Audit: Audit Plan, 2001-02 (Cont'd)

the potential for adverse publicity arising from errors or misconduct. Those factors were ranked and weighted. Surveys were sent to each budget unit and the responses were used to calculate a risk score. The units were then ranked and the Department used its judgement to separate the scores into the three groups: high- moderate- and low-risk. The risk assessments were updated on the basis of departmental audits and other information that came to the Internal Audit Department's attention. Mr. Britt would, in ideal circumstances, like to update the database every two years. The Department was considering a web-based application that would allow updating on an on-going basis. It was currently evaluating and costing options. The Chair noted that there were frequent changes in departments' research funding, in departmental personnel and therefore in their internal control environments. Consequently, the frequent updating of the risk-assessment database would be highly desirable.

(d) Internal audit functions at other institutions. In response to questions, Mr. Bowman said that there was, in general, a lower level of internal audit activity at other universities. While there had been some outsourcing of internal audit functions, most other institutions simply appeared willing to accept additional risk in order to contain costs.

(e) Research-grant administration. A member recalled that the Committee had been advised that the administration of research grants was one of the two areas of greatest risk. Did that remain a major area of exposure? Mr. Britt replied that the Research Services Department had been making significant strides in improving both service to researchers and control mechanisms. The administrative system for accounting for research grants had been improved, remedying one serious deficiency - the inability to handle year-ends other than the April 30 end of the University's fiscal year. The system had also been improved to provide for better controls for the principal investigators. Ms Brown recalled that the University had recently been subject of a periodic audit by two of the federal research-granting councils: the Natural Sciences and Engineering Research Council and the Social Sciences and Humanities Research Council. The University had just received the formal report on the audit. The report had commended the University for having procedures in place in a number of areas that represented best practices. That audit report would be distributed to members of the Committee.

(f) Property management and construction. The member recalled that property management and construction had been identified as another high-risk area. Mr. Britt reported that a significant re-organization of the area had taken place following the audit. There was now a substantially improved segregation of duties and a greater centralization of financial services for projects. A review group was developing a system of cash-flow reports for construction projects to the Assistant Vice-President, Operations and Services as well as to the new position of Vice-Provost, Space and Facilities Planning. The Internal Audit Department might well also be providing closer vigilance in the area. Mr. Britt had been invited to develop a proposal to provide, on a cost-recovery basis, internal audit services to the incorporated business ancillaries (the University of Toronto Press, the Innovations Foundation, and the Asset Management Corporation) and, with respect to capital projects, to the Design and Construction Group in Facilities and Services. The Department would add one full-time auditor to be funded by those units.

6. **Internal Audit: Audit Plan, 2001-02** (Cont'd)

Ms Brown and Mr. Charpentier added that the overall policy for the design and execution of capital projects had been under review. A revised policy would be submitted to the Planning and Budget Committee on May 25, 2001 and would also come before the Business Board at its June meeting. The new policy was aimed at establishing a more integrated process for capital projects, replacing the series of hand-offs that characterized the previous process. Project committees would monitor each major project from conception to the building's being handed over for occupation. The new policy had been developed with the aid of extensive consultations over a substantial period of time, and it took into account concerns that had been expressed in the Business Board and the Audit Committee.

In response to a member's question, Ms Brown said that the University did use quantity surveyors to cost projects and did tender most projects to general contractors. On at least one occasion, when there was need to complete a building (the Bahen Centre for Information Technology) very quickly, it had decided to use a construction manager and sequential tendering for various components of the project.

The Chair reported that Business Board had devoted a great deal of time to the subject of capital projects, considering both individual projects and policy and process matters.

The Chair said that the Committee had previously expressed its strong concern about an eleven-year audit cycle (the period of time required for at least one internal audit for all units as well as more frequent audits of high-risk units). The response had been the development of the risk-based audit plan, with concentration on higher risk units. While such an approach was sensible, it was usually the case with such an approach that high-risk units were subject to audit every year. While the Chair understood that the Department was limited by its staff resources, the Chair thought it very important that the University commit the resources required to provide assurance of proper stewardship of its funding and its assets. He asked the cost of providing an annual audit of all high-risk units. Mr. Britt replied that the addition of two trained auditors would go a long way to ensuring that outcome. It was 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.

7. **Report of the Administration**

THE COMMITTEE MOVED *IN CAMERA*

Mr. Britt reported on seven special reviews. Four of them had been operational reviews that had been requested by management and involved no allegation of impropriety. Three special reviews had involved allegations of impropriety. After investigating, the Internal Audit Department had concluded that one allegation was without basis. In two other cases, the Department had concluded that improper actions had taken place and the employment of the staff members involved had been terminated. In one of those cases, the police would be notified and asked to undertake a criminal investigation.

7. Report of the Administration (Cont'd)

THE COMMITTEE CONCLUDED ITS IN CAMERA SESSION

It was AGREED that, upon conclusion of the special reviews and subject to legal advice, the circumstances of the two special reviews, including the names of the staff members and the consequences of their actions, be made public. The Committee stressed the importance of making it clear that wrong-doing would be discovered and that the University would take the strongest possible action.

Ms Brown said that the administration had undertaken to keep the Audit Committee informed of any significant audits taking place at the University. Mr. White had reported earlier on an audit by two of the federal research granting councils and (as noted earlier in the meeting) a copy of the audit report would be distributed to members.

Ms Brown reported that the Canada Customs and Revenue Agency (C.C.R.A.) had notified the University that it had been selected at random for an audit of its pension-plan administration, and it had indicated that the audit would focus on such things as the calculation of commuted value of members' pensions. Because the University had contracted out pension-plan administration, the C.C.R.A would be making a five-day visit to Hewitt and Associates to carry out the audit. In response to member's questions, Ms Brown said that the C.C.R.A. had, to the best of her knowledge, not carried out a similar audit for another pension plan(s) administered by Hewitt and Associates. Given the narrow focus of the C.C.R.A. audit, the outcome could not be used by the University's external auditors to reduce the time of their own audit.

The Chair noted that Ms Brown would make the Committee aware of any future audits of a significant nature.

8. Date of Next Meeting

The Chair reminded members that the final regular meeting of the academic year was scheduled for Wednesday, June 20 at 5:00 p.m. The meeting was a very important one, at which the Committee would review of the audited financial statements for 2000-01.

9. Private Meeting with the Internal Auditor

The Chair reminded members that the Committee, as a matter of course, held an annual private meeting with the internal auditor. Mr. Britt would be invited, pursuant to item 6 of the Audit Committee Terms of Reference, to state "whether adequate cooperation has been received from management and whether management has exerted any undue pressure." Mr. Britt would also be invited to bring to the attention of the Audit Committee any other matters he deemed appropriate.

9. <u>Private Meeting with the Internal Auditor</u> (Cont'd)

Members of the University's administration and the Secretariat absented themselves and the Committee moved *in camera*.

The Committee completed its business *in camera* and moved back to closed session.

The Chair stated that there were no matters arising from the *in camera* meeting that would require action.

The meeting adjourned at 8:00 p.m.

______________________________ Secretary

______________________________ Chair

June 12, 2001