UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 61 OF THE AUDIT COMMITTEE

June 20, 2001

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 20, 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 Paulette L. Kennedy
Ms Kwai Li
Mr. Paul E. Lindblad
Mr. Richard Nunn
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***

Regrets:

Ms Christine A. Capewell
Mr. Roger P. Parkinson

In Attendance:

Mr. Geoff Behm, Ernst & Young*
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**
Mr. Pierre Piché, Acting Controller***
Ms Deborah E. Simon-Edwards, Executive Assistant to the Chief Financial Officer***

* Absented themselves for the consideration of item 4.
** In attendance for item 3.
*** Absented themselves for the consideration of item 7.

ITEMS 3 AND 4 ARE RECOMMENDED TO THE BUSINESS BOARD FOR ITS RECOMMENDATION TO THE GOVERNING COUNCIL

REPORT NUMBER 61 OF THE AUDIT COMMITTEE - June 20, 2001

1. Report of the Previous Meeting

The Chair explained that, on the good advice of the Acting Chief Financial Officer, Report Number 60 had been separated into two sections to allow for limited distribution of the record of the confidential discussion of the Internal Audit Annual Report.

Both parts of Report Number 60 (May 23, 2001) were approved.

2. Business Arising from the Reports of the Previous Meetings

(a) Report Number 57, Item 5(a), Report of the Administration: Audit of Research Grants

The Chair recalled that the Committee had been informed one year ago of the favourable outcome of the audit of the University's research grants by the Natural Sciences and Engineering Research Council and the Social Sciences and Humanities Research Council. At that time, he had asked that the formal report on the audit be distributed to members of the Committee when it was received. That report had been distributed along with members' agenda packages.

(b) Report Number 60, Item 6, Internal Audit: Audit Plan, 2001-02

The Chair recalled that, at the previous meeting, the Committee had "AGREED that the Chair communicate to the President the Audit Committee's strong view that the Internal Audit Department should be provided with the resources necessary to ensure that high-risk units be subject to an annual review." The Chair was scheduled to meet with the President on June 26, and he encouraged members to convey to him before June 26 any other concerns or matters for which Presidential support was important.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001

The Chair reminded the Committee that the audited financial statements were confidential until they were approved by the Audit Committee. Barring the unforeseen, the statements would be public documents at the end of this meeting. He noted that review of the financial statements was an important responsibility of the Audit Committee, with the Governing Council and the Business Board relying on the Committee to review the statements in detail. To assist the Committee with this responsibility, the external auditors had met with the Committee throughout the year and had access to the Committee with and without the administration present.

Ms. Brown began her introduction of the financial statements by sincerely thanking the external auditors and the financial services staff for the good planning and significant commitment that allowed the Audit Committee to be in the position of reviewing the financial statements only seven weeks after year-end. She reported that the statements had received a clean audit. There had been two significant occurrences during the past year that required the

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

auditors' attention, one being the transfer of investments to a new custodian and the other a change in the accounting treatment of employee future benefits. She referred the Committee to the year-end management letter, noting that this was the first year in which the letter was presented at the same time as the statements. This spoke to good organization, in her view. Noting that Mr. Piché would be providing an overview of the financial statements, she was pleased to note that the presentation this year, for the first time, would include five years of data, demonstrating long-term trends. That would provide good context and allow good comparisons.

Through a Powerpoint presentation (attached hereto as Appendix "A"), Mr. Piché spoke to the highlights in the financial statements, identifying major changes from the 2000 financial statements. Among the key points in his presentation were the following.

- **Funds received by source**. Funds received had declined from $1.4-billion in 1999-2000 to $1.2-billion in 2000-01. Mr. Piché recalled that the new accounting principles mandated by the Canadian Institute of Chartered Accountants precluded some of the funds received by the University from being recorded as revenue on the financial statements. Neither funds deferred for future spending ($125.2-million) nor donations and grants to endowments ($54.1-million) had been recognized as revenue in the financial statements. The amounts deferred for future spending would be recorded as revenue in the fiscal year in which the funds were spent on capital projects and research projects. The donations to the endowments were accounted for as direct increases in the endowed funds and were not recorded at all in the statement of operations. The reduction in total funds received from $1.4-billion to $1.2-billion was primarily the result of two factors. First, SuperBuild funding had flowed into the University in 1999-2000 on a one-time-only basis. Second, significant downward trends in the capital markets had resulted in a $103-million reduction in investment income. On the positive side, research grants, both from government and other sources, had increased because of success in attracting funding, especially from the Ontario Innovation Trust, the Canada Foundation for Innovation and the Natural Sciences and Engineering Research Council.

- **Statement of operations and changes in deficit: Revenues and expenses**. Overall, revenue had declined to $1,041.6-million and expenses had increased to 1,107.4-million. Higher expenses included increased spending on salaries and employee benefits and increased costs for materials and supplies as a result of the significant expansion of research activity.

  The year's operations had also benefited from $58.3-million of net transfers. The largest transfer was $57.6-million transferred from the endowments. Because of the poor investment returns during the year, it had been necessary to spend some of the monies previously set aside for capital preservation during years of strong investment returns.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

The overall outcome was a deficit for the year of $7.5-million, bringing the cumulative deficit to $19.2-million. That outcome was in line with the University's long-range budget plan.

- **Investment income on endowments** included interest, dividends, and realized and unrealized capital gains. Mr. Piché displayed a bar graph showing over the past five years: investment income on endowments, annual allocations for spending, and annual amounts reinvested for capital preservation. The graph depicted very well the success of the policy on capital preservation, which had allowed for a continued increase in funds available for spending with no erosion in the value of the endowment capital. For example, the previously reinvested investment earnings in the endowments had been reduced by $57.6-million in 2000-01, including $49.6-million in spending and $8-million in investment losses. However, in 1999-2000, the capital in the endowments had been increased by $92.4-million. Investment income had been $137.5-million, and only $45.1-million had been spent.

  A member asked if the cumulative outcome could be reported. Mr. Piché indicated that such reporting could be provided, although he thought the graph clearly showed the trend. In response to question, the Chair, Ms Brown and Mr. Piché noted that the Policy for Preservation of the Capital of Endowment Funds had been in effect since 1991. Since 1991, it had been necessary to draw down the capital in only two years to maintain the usual payout. Unfortunately, before the inauguration of that policy, the real value of the University's endowment had suffered substantial erosion. The objective of the Policy was to maintain the real value of the endowed funds against erosion and, at the same time, to provide a predictable, steady, and growing payout to meet the costs of endowed chairs, student aid, etc. To achieve those goals, the University paid out 5% of the average market value of units in the endowed pool over the previous four years. That payout was expected to match the long-term real investment return on the endowment funds.

- **Student aid as a percentage of student fees**. There had been a significant increase over the past five years in student aid as a percentage of student-fee revenue. This reflected the University policy to ensure that no student offered admission to a program should be unable to enter or complete that program due to lack of financial means. Spending for scholarships, fellowships and bursaries in 2000-01 had been $68.6-million, an increase from $55.9-million in the previous year. This spending represented 22.9% of revenue from student fees, an increase from 20.3% the previous year.

- **Donations**. The Campaign continued to be very successful, bringing in $98.1 million for the year, consisting of $53.8-million donated to the endowments and $44.3-million of donations for other purposes. That sum did not include a significant amount in pledges, which should be realized within the next year or two.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

- **Government and other grants and contracts received for restricted purposes**. The surge in restricted funding during 1999-2000 had been a reflection of the one-time-only flow of $68.5-million in SuperBuild funds. While grants for capital infrastructure had declined in 2000-01, there had been a substantial new influx of research funds, making the total amount of restricted funding very close to that received in 1999-2000. Of the $287.8-million in capital infrastructure and research funding, $162.5-million had been recorded as revenue and $125.2-million had been deferred for future spending.

- **Government grants for general operations**. The $380.7-million of Government grants for general operations had increased from $357.7-million received the previous year. $17-million of the $23-million increase had been received from the Research Performance Fund and a further $3-million of funding had represented other grants tied to performance.

- **Expenses by category** had remained much the same year over year. The largest increase in spending was for salaries and benefits, but the proportion of spending on this category had increased marginally from 57.8% to 58.0% of overall expense. There had been a significant increase in spending for scholarships, fellowships and bursaries, which had grown from 5.6% to 6.2% of total expense. There had also been growth in spending on materials and supplies as a result of increased research activity, and in repairs and maintenance as the result of increased provincial funding and the spending down of the University Infrastructure Investment Fund.

- **Balance sheet**. Mr. Piché explained the $175.3-million increase in liabilities. $71.6-million was the increase in deferred contributions, representing research work for which funding had been received but the research work not completed by year-end. $53.5-million represented the increase in deferred capital contributions, representing capital projects for which funding had been received that had not been completed by year-end. In both cases, the monies would be recorded as revenue and the liability would be amortized as the work was completed. Finally, $41.3-million represented the requirement that the University record a liability for all employee future benefits rather than only pension benefits. Because assets had also increased, net assets were much the same as the previous year.

- **Net assets**. The largest element of the net assets was the **endowment**, valued at $1.176-billion at year-end, basically unchanged from the previous year. The substantial amount of donations to the endowment fund had been offset by the poor investment returns arising from the difficult financial markets.

  The second element of the net assets consisted of the **funds committed for specific purposes** but unspent as of year-end. They included the fund set aside to match the University's liability under the Supplementary Retirement Arrangement, Departmental

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

trust funds, unexpended operating funds in the departments, a proportion of income received from research grants to be transferred to the divisions on a slip-year basis to help meet the cost of research overhead, funds committed for alteration and renovation projects; and the unspent balance in the transitional funds, the priorities funds and the University Infrastructure Investment Fund. The balance of those funds had declined slightly to $211.3-million. Among the changes in the funds committed for specific purposes were: a reduction in funds set aside for alterations and renovations but unspent at year-end; a reduction in the balance of the University Infrastructure Investment Fund; and a reduction in unexpended operating funds, largely arising from the new accounting for employee future benefits. The unexpended operating funds also included the funds appropriated to the University's divisions but unspent at year-end and carried forward to the new fiscal year as well as, in a few cases, divisional deficits. In all cases, Deans and other division heads were required to submit plans for the use of their carry-forward funds or for the elimination of their deficits.

The third element in the University's net assets was the **investment in capital assets**, which had increased from $161.8-million to $167.7-million.

The final element in the net assets was the **cumulative deficit**, which reduced the net assets by $19.2-million.

- **Endowments**. The total balance of the endowed funds had remained at approximately $1.2-billion. 42.1% of the endowment was dedicated to student aid and a further 26.4% to endowed chairs and professorships. A significant number of endowed chairs had been attracted through the provision of matching funds by the University.

- **Operating fund results**. Mr. Piché reported the results of the operating fund for 2000-01. The operating fund covered basic University operations and excluded the ancillary operations, the capital program, and operations funded by restricted funds such as research grants. Revenue in the operating fund had increased from $724.8-million to $780.0-million, the result of the increase in operating grant funding and in tuition-fee income, the latter reflecting both a tuition-fee increase and an enrolment increase. Expenditures had also increased from $693.8-million to $774.0-million, largely for salaries and benefits and for student aid. After net transfers of $11.8-million out of the operating fund, the outcome was a deficit of $5.8-million on the year's operations. That deficit was in line with the long-range budget plan and represented a favourable variance from the most recent forecast presented to the Business Board, which had projected a deficit of $6.8-million.

- **Notes to the financial statements**. Mr. Piché reported that two changes had been made to the draft of the notes to the financial statements reviewed by the Committee at the

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

previous meeting. Both changes were made in response to discussion at that meeting. Note 2(g) on foreign currency translation was added. Note 4(a) on derivative financial instruments was expanded to provide information on foreign-exchange forward contracts.

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

(a) Unexpended operating funds: divisional carry-forwards and deficits. In response to a member's question, Ms Brown and Mr. Piché said that the University provided operating departments with budgets annually. Any amount not expended during the financial year could be carried forward to the following year. This allowed divisions to set aside funds for future expenditures. In certain cases, divisions also carried forward deficits. The University of Toronto at Scarborough, the School of Continuing Studies, the Rotman School of Management and the Faculty of Dentistry had varying amounts of deficit. In all cases, the divisions were required to submit plans for the use of their carry-forward funds or for the timely elimination of their deficits. Those plans were tied in to long-range budget plans.

Responding to a member's question about how quickly divisions pay back a deficit, Ms. Brown said that depended on circumstances. The School of Continuing Studies had been a great success story, having reduced a large deficit to $243,000 this year and having a solid plan for the complete elimination of the remaining deficit by strategic planning of its course offerings and improvement of its cost controls. The Rotman School of Management was in a $5.3-million deficit position because of a plan that allowed for the rapid expansion of its M.B.A. program and a deficit payback over the longer term. The University of Toronto at Scarborough had a $2.7-million deficit because of an experiment with Responsibility Centre Management, which had been ended a year ago but during which full overhead expenses had been assigned to the UTSc. UTSc would be assisted to manage its expected rapid expansion and its current deficit.

A member asked for an explanation of the $12.1-million deficit attributable to the Campaign. Ms. Brown replied that, for the first time in 2000-01, the Development division had been provided with a base budget for Campaign expenses. Previously, those expenses had been funded by one-time-only allocations including interest that was being earned over time during a hold-back period for all donations. Donations were held for four months before being released to a division or added to endowments. Interest earned during the four months was retained in the Development budget. Donors were aware of the hold-back plan. Because of the time lag between the significant costs at the front end of a campaign and the receipt of donations, expenses had not been fully offset by the interest on the holdback, and the current deficit had accumulated. Then, when it had been decided to extend the Campaign, it had become clear that the Campaign costs would have to be funded in part through the base budget. Elimination of the deficit would take place over a planned period from interest on the holdback, while at the same time new expenses would be covered out of the base-budget allocation. In response to a question, Ms Brown and Mr. Piché said that the amount could not be capitalized and amortized

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

over a given period because there was no guarantee that the income would be received on a particular schedule. The amount was not an accrual; the expenditures had been made.

The Chair raised the question of the Audit Committee's responsibility with respect to the divisional carry-forwards and deficits. The Committee's key responsibility was to ensure that there was proper scrutiny of those amounts and that proper controls were in place with respect to divisional deficits. In the case of the Rotman School of Management, for example, it appeared that the School was implementing an ambitious plan to expand its enrolment, that the plan had been through a rigorous review process, and that the Provost had exercised his authority to permit a planned deficit in the light of a reasoned plan to pay it off.

Ms Brown confirmed that controls were in place to manage deficit financing in a responsible way. Those controls were based on the long-range budget plan and on the annual budget. Spending was monitored against the budget, and all divisions were required to submit two budget forecasts annually. A summary written forecast was presented at least annually to the Business Board. In response to a question, Mr. Bowman confirmed that the external auditors were satisfied that strong budget controls were in place.

(b) Self-funded programs. A member noted that the financial statements and the Supplementary Financial Report did not distinguish between publicly funded and self-funded programs. He asked if there was information on the self-funded programs. Specifically, the member wondered if there had been cross-subsidization between self-funded and publicly funded programs. Ms. Brown responded that much more detailed financial information was provided for review by the Provost and was considered within the management exchange between the Provost and the Dean.

(c) Supplementary financial report. In response to questions, Ms. Brown said that, while the Financial Statements were distributed broadly, the Supplementary Financial Report was for distribution within the University community only. It was not audited and was made available to University readers to provide more information on each of the four funds that were shown in the financial statements as a single column. Mr. Behm added that the Supplementary Financial Report had been cross-referenced to the financial statements to ensure consistency, and the Committee could, therefore, be assured of the Supplementary Financial Report's accuracy.

(d) Divisional income. In response to a question, Mr. Piché said that general University income included funding from sources such as grants and fees that benefited the University as a whole. That funding was assigned though the budget process. Divisional income was earned by the divisions and stayed in those divisions, with any fluctuations affecting only the relevant unit. Sources of divisional income included, for example, fees for continuing education courses and fees for services such as field trips and photocopying.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

(e) Bridge financing for capital projects. In response to a member's question about Supplementary Schedule 13, Capital Fund: Analysis of Fund Balance, Mr. Piché said that the fund balance in the capital fund arose from differences in the timing of funding received for capital projects and the expenditure of that funding. That balance could be used for bridge financing of other projects. That bridge financing would be repaid when permanent funding for the project was received. In most cases, the bridge financing was planned, although in other cases projects ran over budget, for example Graduate House, and additional permanent funding would have to be found.

(f) Donations. A member proposed that Supplementary Schedule 19, Donations Received, include somewhat more detail, in particular the donations received by Hart House. Ms Brown replied that all donations representing less than 4% of the total were included under the caption "other faculties." While it would be possible to consider reducing the threshold for individual reporting, there was no certainty that a particular cutoff would include the donations received by Hart House or any other unit.

(g) Foreign currency hedging. In response to questions, Mr. Lindsey said that 50% of all significant foreign-currency investments were hedged back to the Canadian dollar. The University retained exposure to the remaining 50%. If the foreign currency declined relative to the Canadian dollar, the hedge would help reduce the loss. If, on the other hand, the foreign currency gained, the hedged portion would not deliver the gain, but the unhedged portion would do so. The objective was to reduce the additional volatility of the foreign investments arising from currency exposure and to achieve a return closer to that provided by the foreign securities markets to domestic investors. Gains or losses on the currency forward contracts were recorded as investment income. Note 4(a) provided the notional value of outstanding foreign currency contracts. The hedges were entirely passive; neither the University of Toronto Asset Management Corporation (UTAM) nor its foreign-exchange manager took a view on currency values in an effort to enhance portfolio return. Gains and losses on forward contracts were realized monthly.

(h) Investments. In response to questions, Mr. Lindsey said that UTAM did not use derivative instruments such as "put options" to hedge against losses in equity portfolios. The volatility of portfolios was currently so high that the cost of hedging would be substantial. Rather, UTAM used broad diversification and active strategies to seek to add value above index returns. For the thirteen-month period May 1, 2000 to May 31, 2001, had UTAM not used active strategies, the Long-Term Capital Appreciation Pool (the pool containing most of the endowed funds and a portion of the expendable funds) would have suffered a loss of $65.7-million. In fact, UTAM's strategies had mitigated the loss and provided a gain of $3.7-million.

In response to other questions, Mr. Lindsey said that all investments were currently managed by external portfolio managers selected by UTAM. A substantial portion of the investments was in index funds, where portfolio turnover was very low. Another portion was in the hands of active managers. Some managed core portfolios with relatively little turnover in the shares held and

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

others managed more concentrated portfolios, in which turnover could be much faster. UTAM did not currently invest in covered rights, although it was looking at that strategy. The strategy would not add to the ultimate return on any stock, but it would deliver the returns at an earlier date. While that would improve returns only marginally, it was important to seek every enhancement possible in the current difficult market conditions when it was a challenge even to preserve the value of invested capital. Moreover, the use of covered rights would add to diversification.

In response to another question, Mr. Lindsey said that the University's investments in real estate consisted of two pooled funds in which the University had invested in the early 1990s. They both generated income, which was accounted for as investment revenue.

The Chair noted that the category of "Pooled funds" accounted for $1.5-billion of the $1.8-billion of University investments. Mr. Lindsey said that this category consisted primarily of investments in index funds. The categories "Canadian equities," "United States equities," and "Other international equities" represented segregated portfolios specifically selected for the University by the active, external investment managers.

(i) Auditing investments. The Chair recalled a member's request, made at the previous meeting, that the external auditors comment on their approach to auditing the invested assets and to determining the fairness of their valuation. Mr. Behm reported that the University had changed the custodian of its investment funds to State Street Canada - a changeover that required considerable additional audit work to ensure the completeness of the transfer. Key procedures in the external auditors' regular audit examination included the review of the monthly reconciliations between the custodian's (State Street's) and the various investment managers' portfolio valuations, which were marked to market, and a review of their year-end valuations and their tie-in to the monthly reconciliations. The audit had found no discrepancies and would follow up on any discrepancies that did appear in future years. Ernst & Young had also received and reviewed a report from the custodians' external auditors, who had reviewed State Street's purchases, sales and pricing. That audit was performed annually, and the most recent audit report was unqualified. Ernst & Young also dealt with State Street on behalf of other clients and performed an annual audit of its purchases, sales and pricing. On the basis of this work, Ernst & Young was very comfortable with the University's accounting for its investments.

In response to a question, Mr. Lindsey said that State Street was not the custodian for the University's private-equity investments. But, the limited partnerships that managed those various investments provided an annual report to State Street, Mr. Behm said that Ernst & Young's audit spent relatively more time in reviewing the private-equity investments. Mr. Lindsey noted that the University had committed little over 2% of its investment funds to private-equity investments, and to date only a small proportion of the money committed to those investments had actually been drawn down by the external managers.

3. Audited Financial Statements and Supplementary Financial Report for the Year ended April 30th, 2001 (Cont'd)

On the recommendation of the Acting Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

THAT the University of Toronto audited financial statements for the fiscal year ended April 30th, 2001, a copy of which is attached hereto as Appendix "B", be approved.

The Chair said that it was remarkable that the Committee could on June 20 be considering April 30 financial statements for so complex an institution as the University of Toronto. He congratulated Ms Brown, Mr. Piché, Mr. Britt, Mr. Bowman, Ms Brouwer and all of the members of their staffs on their work.

Mr. Bowman said that the Canadian Institute of Chartered Accountants required that external auditors submit to audit committees a letter providing assurances of their independence. He gave oral assurance that there were no matters that would impair Ernst & Young's independence or their audit opinion, and he undertook to deliver a letter to that effect the following day. The Committee agreed that the arrangement would be acceptable.

Ms Brown noted that the report on the external auditors' other assignments for the University usually appeared on the agenda of the first meeting of the fall (at the same time as the presentation of the report on audit fees). The 2000-01 list of assignments would not differ appreciably from the previous year, and the Committee had concluded one year ago that the list of other assignments provided no cause for concern about the auditors' independence.

4. External Auditors: Appointment for 2001 - 02

Ms Brown recommended that Ernst & Young be reappointed as the external auditors for the University and the pension plans, and that the directors of the University of Toronto Innovations Foundation be asked to re-appoint Ernst & Young as the external auditors of that corporation. With approval of the recommendation, Ernst & Young would also become the external auditors of the other two incorporated business ancillary operations - the University of Toronto Asset Management Corporation and the University of Toronto Press - by virtue of the agreements between those corporations and the University. Ms Brown said that she had been very pleased by the organization and procedures of the audit. The audit team had been a highly competent one. The Principal who had managed the audit, Ms Diana Brouwer, was very capable, and Ms Brown commended her ability, efficiency, depth of knowledge, professionalism and audit planning. In order to refresh the relationship between the University and its long-standing auditors, Ernst & Young had in 1998 assigned a new partner to take charge of the Audit,
Mr. Bowman. Mr. Piché echoed Ms Brown's endorsement. The external auditors had focused their audit on areas of risk and had asked the right questions in dealing with those areas.

4. <u>External Auditors: Appointment for 2001 - 02</u> (Cont'd)

Two matters arose in discussion.

(a) Other assignments and the auditors' independence. A member asked about the relative amount of fees paid to Ernst & Young for work other than the audit. Ms Brown recalled that the Committee received a detailed report each fall on all fees paid to Ernst & Young. The various audits performed for the University and its ancillary operations represented the bulk of the firm's work. They did also carry out some consulting assignments. The firm was called on for tax consulting as required, and it also took the initiative to present ideas for savings, which were provided on a contingency-fee basis. The firm's advice had enabled the University to enjoy substantial savings on the Goods and Services Tax, for example. The firm had also provided a study of various means that could be used for the University's forthcoming major borrowing for capital projects. The fees involved were relatively small and would not put the firm's independence at risk. For example, the tax consulting work had amounted to about $15,000 and the study on capital borrowing about $30,000. The Chair observed that if the fees paid to Ernst & Young for consulting were in line with those paid in previous years, they would not represent a significant proportion of the total.

The Chair suggested that it might be appropriate in the future to present the report on audit fees and consulting work to the June meeting, along with the recommendation for the appointment of auditors. Ms Brown replied that she would be pleased to consider doing so. The major advantage of presenting the report in the fall was that it could include the comparative data provided in the report on audit fee prepared annually by the Council of Financial Officers - Universities of Ontario.

A member recalled that Ernst & Young had provided an oral assurance of their independence and had undertaken to supply that assurance in writing the next day. Her support for the firm's re-appointment was conditional on the understanding that the written assurance of independence would be provided. Ms Brown noted that the requirement for a written assurance of independence had been established recently by the Canadian Institute of Chartered Accountants. The University's Audit Committee had, however, been ensuring independence for many years through its complete review of the full slate of the auditor's assignments for the University and their compensation.

(b) Review of audit services. The Chair referred to the requirement in the University's Purchasing policy that on-going, central, consulting and professional services such as audit services were subject to review every five years. A member observed that the administration had in the past made it clear that it did not wish to make a change in the audit firm. He was, however, concerned that complacency could set in.

Ms Brown replied that the administration had reviewed the University's audit services within the past five years and had decided to recommend no change. The risk of complacency had been dealt with by changes in the partner responsible for the audit. Mr. Bowman, for example, was

4. External Auditors: Appointment for 2001 - 02 (Cont'd)

the third partner with whom Ms Brown personally had worked. The value of carrying on with the same audit firm was continuity, a matter of particular importance in so complex an institution as the University of Toronto.

(c) Services provided on a contingency-fee basis. A member expressed concern about services being provided on a contingency-fee basis. The Chair noted that changes in the Institute's rules now permitted the use of contingency fees in certain circumstances. Ms. Brown noted that a group of Ontario universities had tendered for tax consulting services to be provided on a contingency-fee basis, with the firm retaining a proportion of the savings it generated. The group of universities had hired another accounting firm, which had spent a great deal of time at the University of Toronto seeking out additional savings, but failing to find any and failing to earn any fee for a great deal of work. Ms Brown observed that such work had become a standard practice in the accounting profession.

On the recommendation of the Acting Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

(a) THAT Ernst & Young be re-appointed as external auditors of the University of Toronto for the fiscal year ending April 30, 2002;

(b) THAT Ernst & Young be re-appointed as external auditors of the University of Toronto pension funds for the fiscal year ending June 30, 2002; and

(c) THAT the members of the University of Toronto Innovations Foundation be requested to appoint Ernst & Young as the external auditors of the Foundation for the fiscal year ending April 30th, 2002 at a remuneration to be fixed by the Directors of the Foundation.

5. External Auditors' Management Letter arising from the 2001 Year-End Audit

Mr. Bowman said that the management letter was the standard one when there were no major recommendations. The time spent by the external auditors with the key University staff and with the Audit Committee in advance of the audit had enabled Ernst & Young to complete the audit in two days' less time than the previous year. No issues had arisen during the audit to cause delay, and the audit had been a clean one.

Ms Brown said that she was very pleased with the management letter and with the external auditors' level of satisfaction with the University's controls. She noted that the external auditors also provided a letter of recommendations to the administration which dealt with issues that they

5. External Auditors' Management Letter arising from the 2001 Year-End Audit (Cont'd)

deemed not sufficiently broad ranging to bring to the attention of the Committee. That letter had dealt largely with matters of computer security. Recommendations included particular items concerning access to the systems and a general recommendation for a disaster-recovery plan.

Disaster Recovery Plan / Risk Assessment

A member expressed concern that there was no disaster-recovery plan and that the external auditors had deemed its absence a matter that did not merit the attention of the Audit Committee. She observed that most businesses had such a plan.

Mr. Bowman said that the external auditors took the view that the University should formulate an overall disaster-recovery plan. The matter had been an issue for some years and had previously been included in the external auditors' memorandum of recommendations. The University's administration had made a considered decision not to proceed with the formulation of an overall plan, giving higher priority to other needs. In the light of the fact that the administration had made a decision on the recommendation, it had been critical of the external auditors continuing to include it in the management letter to the Committee. The tradition had therefore developed of stating the continuing concern in the letter to management.

Invited to comment, Mr. Britt said that the question of disaster recovery had also been considered at the time of the inauguration of the new Administrative Management Systems. Even in the worst case, the University would be able to continue to carry out its mission. The most substantial problem would be the timely handling of the payroll. There would be no problem of paying suppliers. The matter had been reviewed again when considering the systems' readiness for the transition to the new millennium (the year 2000 problem). It was clear that while there was no formal disaster-recovery plan, there were many back-up systems in place.

Ms Brown noted further that the University had in fact experienced a disaster, when a fire in the Sanford Fleming Building had destroyed the central computers. The University had been able to resume its usual activities almost immediately. Data continued to be backed up daily and stored off site. The University used standard S.A.P. software, with the only loss in the event of a disaster being some customization of the software. Formulating and implementing a full disaster-recovery plan would be very expensive. It would involve much more than computer systems, with attention required for individual research laboratories and other facilities. Given the cost and other pressing needs, the administration had concluded that the present individual measures that were in place were sufficient.

The Chair proposed that the external auditors' letter of recommendations to management be distributed to the Committee for its information to enable it to make a judgement about the need for a formal response. The Chair asked that Ms Brown arrange for an overview of the matter of a disaster-recovery plan to be presented to the Committee in the fall, setting out the needs for and costs of a disaster-recovery plan and, if deemed appropriate, making the case that action was

5. External Auditors' Management Letter arising from the 2001 Year-End Audit (Cont'd)

Disaster Recovery Plan / Risk Assessment (Cont'd)

unnecessary. A member stressed that the absence of such a plan could have a negative impact not only on operations but also on the University's reputation.

Ms Brown said that she would be pleased to provide the auditors' letter to the administration and the administration's response.

After the Committee's private meeting with the external auditors (see item 7, below), the Chair reported that the Committee had continued its consideration of disaster recovery, and it had concluded that it would be very valuable for the Committee to receive, for consideration in the fall, a risk assessment, commenting on the major areas of exposure. The external auditors should be invited to participate in the Committee's discussion of that assessment. While the Committee was not concerned that there were major areas of unacceptable exposure, it was entirely appropriate for the Committee to be up to date on the risk assessment.

Ms Brown noted that Committee had held a substantial orientation session in the fall of 2000. She enquired whether members would like to receive the risk assessment at a comparable orientation or at one of the formal meetings.

The Chair noted that audits began with a risk assessment, and such an assessment was a primary responsibility of the Audit Committee. The Chair invited Ms Brown, Mr. Britt and the external auditors to determine the appropriate context for the presentation of the risk assessment. That presentation should, however, take place before the beginning of the audit process. He noted that the orientation session had been a very helpful one. Because, however, there would be little or no turnover in the voting membership of the Committee, it would probably not be necessary to repeat all of the items from the previous session in the same depth, and that might provide the opportunity for focusing on the key areas of risk. Ms Brown said that she would be pleased to focus the orientation session on the risk assessment, and she invited members to provide ideas for topics to be included.

Two members urged that the risk assessment go beyond dealing with the usual topics and include broader issues of operational risk and reputational risk, for example the risks posed by the double cohort of students graduating from the old five-year and new four-year secondary school programs in 2003, deferred maintenance, and employee retention. Ms Brown noted that responsibility for dealing with some of those areas resided with other Governing Council committees. For example, the Planning and Budget Committee had been dealing with the double-cohort issue, and the Business Board considered annual reports on deferred maintenance and insurance and risk-management. The Chair and a member urged that the Committee be briefed on the location of responsibility for the various areas of risk and be assured that steps were being taken to deal with the risks. Mr. Charpentier undertook that the Secretariat would work with Ms Brown to provide that information.

6. External Auditors' Performance / Value Scorecard

Mr. Bowman invited members' comments on the external auditors' Performance / Value Scorecard. Among the matters that arose in discussion were the following.

(a) Audit Committee participation in determining expectations. The Chair proposed that in future years the Audit Committee participate in setting out the column of the scorecard dealing with "expectations." Mr. Bowman agreed fully with the suggestion. He noted that the Audit Committee had seen a draft of the proposed scorecard in the fall when Ms Brouwer had presented the external audit plan. The Chair concurred with the observation; unfortunately the plan had been presented very late on a very full agenda, and the Committee had not given the matter adequate consideration.

(b) Key issues dealt with in the audit. A member suggested that the scorecard include a report on the most significant issues dealt with in the audit. That would enable both the external auditors and the Committee to make a judgement about how those issues were dealt with.

(c) Cost savings. A member suggested that the scorecard include a report on cost savings produced. Mr. Bowman suggested that such a report might be more useful in the fall when the Committee received the annual report on audit fees and on other assignments completed by Ernst & Young. The firm had in the past year proposed steps that had saved the University $300,000.

THE COMMITTEE MOVED *IN CAMERA*.

7. External Auditors: Private Meeting

The Chair said that the Committee met annually with the external auditors without any member of the administration or the Secretariat in attendance. At the meeting, the auditors were invited: (a) to advise, as stated in the Committee's terms of reference, "whether adequate cooperation has been received from management and whether management has exerted any undue pressure," (b) to comment candidly on the probity and the competence of the University's senior financial officers and its Internal Audit Department, and (c) to respond to members' questions.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair reported that the Committee had agreed that there were no matters arising from the *in camera* session that would require action. The auditors had made very positive comments with respect to the administration's co-operation and performance during the audit, all the more remarkable given the recent retirement of the long-serving Chief Financial Officer. The Committee had concluded that it would be appropriate in the fall to continue its consideration, arising from the external auditors' comments about the need for a disaster-recovery plan, of the risks facing the University. (See item 4 above.)

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8. Report of the Administration

Ms Brown and Mr. Britt stated that there were no other matters that should be drawn to the attention of the Audit Committee at this time.

9. Date of Next Meeting

The Chair advised members that the interim date of the next meeting was Wednesday, September 12, 2001. [Secretary's Note: that date was subsequently changed to Wednesday, November 7, 2001.]

10. Other Business

Chair's Remarks

The Chair thanked all members for their participation and contributions throughout the year. He also thanked all of the University staff who had contributed to the Committee's work.

The meeting adjourned at 7:40 p.m.

Secretary	Chair

August 14, 2001

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