UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 103 OF THE AUDIT COMMITTEE

June 13, 2012

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 13, 2012 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Ms Paulette L. Kennedy (In the Chair)
Mr. W. John Switzer
Mr. Chris Thatcher

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

Mr. Neil Dobbs, Secretary*

Regrets:

Mr. J. Mark Gardhouse
Mr. Steven (Suresh) Gupta
Ms Penny Somerville

In Attendance:

Ms Stephanie Chung, Ernst & Young**
Mr. Eric G. Fleming, Director, Risk Management and Insurance****
Mr. John Kerr, Director-Designate, Risk Management and Insurance****
Mr. Pierre G. Piché, Controller and Director of Financial Services*
Ms Martha J. Tory, Ernst & Young**

* Absented themselves for item 4(c) and 11.
** Absented themselves for item 4 and 11.
*** Absented himself for item 4(c).
**** In attendance items 1 - 3. Mr. Kerr also in attendance for certain later items.

ITEMS 3 AND 4 CONTAIN RECOMMENDATIONS TO THE BUSINESS BOARD FOR GOVERNING COUNCIL APPROVAL. ALL OTHER ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

1. Report of the Previous Meeting

Report Number 102 (May 9, 2012) was approved. The Chair noted that a confidential Appendix to the Report, dealing with the Committee's review of the risk-assessment profile, would follow.

2. Business Arising from the Minutes

The Chair reported that the Committee's first meeting for 2012-13 would be held on Wednesday, October 10, 2012. It would deal with three matters that had arisen at the previous meeting in the discussion of the Risk-Assessment Profile. The Committee would receive:

- A further risk assessment in the area of information technology on: risk identification, measurement and mitigation with reference to a risk control framework such as COBIT [originally an acronym for Control Objectives for Information and Related Technologies]; a discussion of the nature of information-technology spending (central versus distributed); and differences in control and oversight between those two levels;
- a review of risk identification and mitigation with respect to research activities; and
- a report from Internal Audit on its activities in relation to the risk-mitigation factors identified in management's Risk-Assessment Profile.

3. Risk Management and Insurance: Annual Report, 2011-12

The Chair said that it had been decided one year ago that, in the light of the review of the annual report on Insurance and Risk Management by the Audit Committee, it would be superfluous for the report to be forwarded to the Business Board for further review. Ms Brown said that Mr. Fleming would, after nearly thirty years of outstanding service to the University as Director of Risk Management and Insurance, be retiring at the end of the current academic year. The University owed him a considerable debt of gratitude. Ms Brown introduced and welcomed Mr. Fleming's successor, Mr. John Kerr. Mr. Fleming thanked Ms Brown for her kind words. He had enjoyed his time at the University, had met wonderful people, and considered himself lucky to have been a member of the University's staff.

Mr. Fleming was pleased to report that 2011-12 had been a good year overall for the University's insurance and related risk-management program. It continued to purchase all insurance in the commercial marketplace, and it had been able to renew all major policies with favourable prices and coverages. That had been possible because of the University's good claims experience, its excellent reputation, and its stress to its insurers of its constrained resource and budgetary circumstances. The terms of the property and liability policies remained superior to those available from the Canadian Universities Reciprocal Insurance Exchange (CURIE), which the University had left in 2008. While some insurers had pressed for rate increases, the University had been able to resist that pressure by having alternative insurers available who would provide the desired coverage at the desired rates, which were somewhat below those of the previous year.

Mr. Fleming reviewed the University's main insurance policies funded by the central operating budget, and the insurers that provided them. All policies had been retimed so that they coincided with the University's fiscal year beginning on May 1. Insurance coverage included the following:

3. Risk Management and Insurance: Annual Report, 2011-12 (Cont'd)

- Property policy: limit of $500-million per loss (on total insured property valued at nearly $6.5-billion). Deductible of $250,000.
- General liability, errors and omissions, and vehicle fleet policies: aggregate limit (of the primary policy in each area plus umbrella and excess liability policies) $35-million per loss. Deductible of $10,000 per loss for the general liability and errors and omissions policy; no deductible for the vehicle liability policy.
- Boiler and machinery policy: limit of $100-million of loss for accidental machinery breakdown. Deductible of $25,000 for all machinery except the large chillers, for which the deductible was $100,000.
- Composite crime policy: limit of loss of $25-million for theft of money or securities or other breach of fiduciary responsibility by employees. Deductible is $15,000 or $50,000 depending on the category of claim.

The University also funded a policy to cover property owned by faculty or staff and used in their professional capacity where the individual's coverage was inadequate. Finally, it purchased certain policies to meet the special needs of individual departments, with the premiums funded by the users.

Mr. Fleming stated that the University was very pleased with the work of its insurance brokers, HKMB Hubb International Limited, who assisted the University with the purchase of its property and liability policies. He continued to be satisfied with the University's decision to purchase its insurance through the commercial market, having achieved substantial on-going savings as the result of its move from CURIE. While the University's insurance claims record continued to be excellent, there had been two substantial claims. There had for some years been a problematic level of claims under the boiler and machinery policy. In 2011-12, another substantial claim had arisen from the failure of a pumping system in a laboratory in the Department of Comparative Medicine, resulting in the immersion and destruction of a complex effluent-decontamination machine at a cost of about $450,000. The loss was covered by both the boiler and machinery policy and, as water damage, by the property policy, and it was expected that the cost would be shared by the two insurers in a proportion to be negotiated. The other substantial claim had arisen under the crime policy as the result of a defalcation by a long-term employee (who had been dismissed for cause), as reported to the Committee at its May meeting. The loss amounted to about $333,000. Staff in the Finance division and in the Internal Audit Department had done very good work in documenting the matter both for the insurers and for the police, and Mr. Fleming was confident that the amount of the loss, minus a $15,000 policy deductible, would be covered by the insurer.

Mr. Fleming recalled that the investment earnings on the University's self-insurance reserve were used to pay the cost of property policy deductibles minus a $2,500 "responsibility" amount that was absorbed by the department incurring the insurable loss. The $54,000 payout from the reserve for 2011-12 was substantially greater than the investment earnings and was somewhat higher than the previous year, but it was within the prediction margins. Funding provided through a multi-year transfer from the operating budget to rebuild the reserve had been added to it, as was an unexpected dividend from CURIE. The reserve was on target to achieve its sustainable level over time.

3. Risk Management and Insurance: Annual Report, 2011-12 (Cont'd)

A member asked about the insurance implications of the University's hosting elements of the forthcoming Pan-American Games. Presumably, the Games would draw large numbers of visitors to the St. George and Scarborough campuses. Mr. Fleming replied that the Risk Management and Insurance Department was currently working on an agreement concerning insurance for the Aquatic Centre to be built on the Scarborough Campus. The Centre would be jointly owned by the City of Toronto and the University, and there was need to agree on the division of responsibility for insurance among the Toronto 2015 group responsible for the games, the City, and the University. That would require decisions concerning potential liability and continuity of coverage.

In the course of the discussion, it was agreed that the table showing the status of the reserve fund (on page 8 of the current report) would be amended for the next year's report. The objective would be to avoid the impression that the elements of the table should add to the balance as at year end. It would be made clear that the elements shown were selected highlights for the fund rather than all elements contributing to its year-end balance.

Speaking on behalf of the Committee, the Chair thanked Mr. Fleming for all of his excellent work over the years and wished him well in his retirement.

4. Audited Financial Statements for the Year Ended April 30, 2012

The Chair noted that the audited financial statements were before the Committee for recommendation to the Business Board (and from there to the Governing Council). The remainder of the *Financial Report* – the "Highlights" and the "Supplementary Report by Fund" – were for information. She thanked Ms Brown, Mr. Piché, Ms Tory, Mr. Britt and their colleagues for the work in preparing the statements for the year ended April 30 in time for a meeting of the Audit Committee in mid-June. Their achievement was a major one.

Ms Brown said that the financial results for the year represented good news. The financial outcome for the year was not at all bad given the difficult global financial conditions for the year, which had led to relatively poor investment returns. The statements represented a better outcome than the projection that had been presented to the Business Board in the financial forecast for the year. She echoed the Chair's thanks to those responsible for the rapid completion of the financial statements. Mr. Piché and his colleagues worked on the statements throughout the year and completed them very expeditiously after the fiscal year-end. The first draft had been ready by May 15, with no real change to the numbers after that date.

(a) Highlights of the Financial Statements

Mr. Piché presented the highlights of the financial statements. His presentation slides are attached hereto as Appendix "A". In his presentation, Mr. Piché reviewed the operations included in the financial statements (and excluded from them) and the significant accounting concepts used (particularly those that differed from concepts used in the business world). He

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

observed the interdependency of (a) the growth of the University's enrolment, faculty, and buildings with (b) the income, expense and balance-sheet components reported in the financial statements.

- **Overall financial result for the year**. For 2011-12, the University had basically operated on a break-even basis. The $34.5-million net loss was the outcome of the exceptionally low current interest rate, which had brought about an increase in the estimate of the University's unfunded pension-plan obligation, which had to be recorded in the University's accounts for the year.

- **Revenues**. The major source of growth in revenue was in student fees. Revenue from that source had grown significantly from $764-million to $847-million, primarily because of the increase in the University's enrolment but secondarily because of the increase in the level of fees. The number of international students had grown substantially, contributing to the overall increase in revenue from student fees. There had been relatively little change in other sources of revenue. Revenue from government grants had increased only marginally from $691-million to $702-million.

- **Government grants for capital purposes**. For 2011-12, the University had received $73-million of capital grants for infrastructure and certain other purposes. Projects funded included the Goldring Centre for High-Performance Sport and the federal government contribution to the Munk School of Global Affairs. While funding in 2011-12 had been substantially less than the $142-million received in 2010-11, the funding in that previous year had included some of the $150-million grant from the federal and provincial governments for the major Knowledge Infrastructure Program – grants made at the time to stimulate the economy. Capital funding had also been exceptionally high for 2008-09. The $131-million received in that year had included funding for the provincial contribution for the Munk School of Global Affairs and the grant for the Martin Prosperity Institute.

- **Grants for research** had not varied substantially over the past five years. There had been a reduction in funding arising from the University's reduced allocation for Canada Research Chairs, offset by increases in some years in funding for research facilities from the Canada Foundation for Innovation.

- **Donations**. Donations of $83.5-million for 2011-12 were similar in amount to those received over the previous two years. However, arising from the announcement of the "Boundless" fundraising campaign, pledges had increased very substantially, bringing the total for gifts and pledges to $128.5-million.

- **Expenses** for the year had amounted to $2.4-billion. There had been a major increase in the expense for salaries and benefits from $1.46-billion to $1.54 billion arising from the increase

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

in the amount recorded for employee future benefits. Because of low interest rates, there had been need to increase the recorded expense for employee future benefits from $278.3-million in 2010-11 to $299.5-million in 2011-12. On an accounting basis, the deficit in the pension plan as at April 30, 2012 had been recorded at $1.98-billion.

- **Assets, liabilities and net assets**. Liabilities had increased in 2011-2 in part because of the $200-million Series E debenture issue. Net assets were lower by $51.5-million because of net loss for the year of $34.5-million and the loss on externally restricted endowments of $43.1-million, offset by externally restricted donations and grants to the endowments together amounting to $26.1-million.

  Net assets as at the end of the year had been $1.84-billion. The major component of net assets was the endowment fund, which amounted to $1.52-billion. The endowment payout had exceeded the 1% investment return. With the addition of the donations and grants to the endowment, its value had remained fairly flat, declining somewhat from $1.54-billion. The outcome of the payout in excess of investment earnings plus inflation was a drawdown of $84.2-million in the amount that would ideally have been reserved for the preservation of the value of the endowment against erosion by inflation. The long-term target investment return for the endowment fund was inflation (as measured by the Consumer Price Index) plus 4%. That long-term target had been exceeded in six of the past ten years. However, as at April 30, 2012, the ten-year rolling-average return of 2.7% was well below the 6.2% ten-year rolling-average target.

  The largest element in the endowment was the $655-million supporting student aid, followed by the $460-million supporting endowed Chairs and Professorships. Other endowment funds supported particular academic and research programs.

- **Borrowing**. External borrowing had increased to $722.6-million as the result of the $200-million Series E debenture issue. At the same time, maximum external borrowing capacity (defined as 40% of net assets averaged over the past five years) had declined to $746.6-million as a result of the small decline in net assets as at the 2011-12 year-end.

- **Financial results compared to forecast**. Early in each calendar year, the administration presented to the Business Board a forecast of the financial results for the fiscal year ending April 30. For 2011-12, the forecasted financial result for the year had been a net loss of $108.6-million. The actual result was a loss of $34.5-million. The divisions had saved about $40-million more than projected, and the amount of acquired fixed assets that could be capitalized had been about $14-million more than projected. Other projections had been close to actual results.

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

Mr. Piché recalled that the Committee had at its May meeting reviewed the draft notes to the financial statements. There had since that meeting been only two substantial changes made to the notes, both concerning the recording of investment earnings on the endowment. On page 32, note 2(a) – Summary of significant accounting policies and reporting practices: Investments and Investment Income – and on page 76, note 16 – Endowments – the wording was revised to explain the accounting for investment earnings or losses on externally restricted endowments.[1]

Numerous matters arose in questions and discussion. Among them were the following.

(i) Research funding. A member referred to a statement in Financial Highlights concerning research funding. While the direct expenses of research were offset by additional revenues, the "growth in research results in the need for additional space and renovated space for conducting research as well as an increase in indirect costs which are not fully recovered by the University." Research therefore was an activity that involved financial risk and subsidy from other University revenue. The member asked what amount of the University's net deficit had been caused by undertaking research. Ms Brown replied that, as the result of strong advocacy efforts, as of the year 2000, the three major Canadian research-granting agencies had begun providing some funding for overhead costs to the universities along with their grants to researchers. The pool for such overhead funding amounted to about 20% of the amount of research grants awarded. However, the funding was provided according to a sliding scale, with a higher proportion of funding provided to smaller universities. The University of Toronto received overhead funding amounting to only about 17% - 18% of the grants received by its faculty. In the United States, research overhead funding amounted to something like 57% of the amount of research grants. In response to a question, Ms Brown said that the overhead expense included: the cost of space and utilities; the services of central administrative offices in assisting faculty members to learn of and apply for grants; accounting for grants and reporting on them; central services such as library and computing services; and departmental services for research laboratories. Mr. Piché guessed that the total cost of services to holders of research grants would amount to something between $40-million and $50-million. Ms. Brown said that vigorous advocacy for the full funding of overhead costs was on-going, but it had to date not yielded payments beyond the 20% pool now provided.

(ii) Construction of facilities for ancillary operations. A member observed that some years ago, the student residence operations had incurred substantial debt for the construction of new buildings. While the result had been deficits in the residence operations for some years, it appeared that the operations were now generating positive cash flow. Mr. Brown replied that the observation was a correct one, both for most residence operations and for the parking operations.

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[1] Note 2(b) now reads as follows. For "investment income earned on externally restricted endowments, . . . only the amount made available for spending is recorded as revenue. In years where the investment income earned is in excess of the amount made available for spending, the excess is recorded as a direct increase of endowments. In years where the investment income earned is below the amount made available for spending, the shortfall is recorded as a direct decrease of endowments."

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

It had been planned that several of those ancillary operations would incur debt for the construction of new facilities and would undertake repayment of that debt through fixed payments of blended principal and interest. It had been projected that they would incur operating deficits for about eight years. Then, as rates for residences and parking increased over time, the operations would after about eight years begin to generate positive cash flow and would begin the process of reducing and eventually eliminating their deficits. The staff in those operations had worked very hard to achieve that desirable outcome. For example, the staff responsible for the residence operations had been able to attract business in the summer from people other than students, when many residence rooms would otherwise have remained empty.

(b) External Auditors' Report on Audit Results

Ms Tory observed that the University's Finance group had been extraordinarily well organized and prepared for the audit of the financial statements. It was truly remarkable that the April 30 financial statements were available for presentation to the auditors for a closing meeting before the end of May. The auditors would issue their final opinion upon approval of the statements by the Governing Council. Ms Tory commented on a number of items of audit significance that had been discussed with management. They included the following.

- **UTAM pooled funds**. The University of Toronto Asset Management Corporation (UTAM) had established new pooled funds to hold investments in each of the major publicly traded asset classes. The pension fund and the Long-Term Capital Appreciation Pool (the endowment fund and other long-term funds) then held units in those pools. That new structure would enable the fund managers to make only a single trade both to buy or sell securities for both funds, achieving cost savings.

- **Valuation of securities**. The auditors had completed substantial work to verify the values of the over $600-million of UTAM investments that were not publicly traded securities, and they had concluded that the values recorded represented reasonable estimates of their value.

- **Accruals for salaries, benefits and other payments to employees for 2011-12**. In a number of cases, negotiations with employee groups for salaries and benefits for the 2011-12 fiscal year had not been completed. The auditors had concluded that management's estimate of the cost of increases for those groups, included as accrued expense in the Statement of Operations, was a reasonable one. In some cases, agreements reached after the year-end had corresponded well with the estimates used for the accrual. Similarly, the auditors had reviewed the accruals for payments to be made to (a) members of the United Steelworkers Union for retroactive pay-equity payments, and to (b) faculty members, librarians and professional and managerial employees under the retirement-incentive programs for those employee groups. Again, the auditors had found the accruals to be reasonable.

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

- **U.T.S.C. land remediation costs**. The University had capitalized its cost incurred to remediate land at the Scarborough Campus (previously a municipal waste site) to serve as the location of an athletic facility to be used initially for elements of the Pan-American Games. The external auditors concurred with this accounting treatment.

- **Fund deficits**. The Committee had over the past two years discussed the accounting used for externally restricted research grants. Certain granting agencies required the University to send invoices or requests for disbursements in order to receive payments for costs incurred pursuant to the research grants. That meant that the expense had to be incurred before payment was received, creating a deficit in the account. The auditors took the view that in such situations, the University should record a receivable. However, it agreed that, because the amounts involved were not outside the boundary of materiality, it was not necessary for the University to change its classification of these amounts as elements of its fund deficits. The auditors were particularly concerned that the University apply its accounting treatment only in those cases where there was an agreement that the granting agency would reimburse the University for its cost, and that the University would establish a provision in any other cases where reimbursement was not assured.

  A member asked about controls to prevent overspending in accounts funded by research grants. Such overspending would presumably represent a real financial risk for the University. Ms Brown replied that there were two types of controls, both involving regular fund-checking of such accounts. With respect to non-salary expenses, if a researcher sought to pay an expense from an account with inadequate funding, that payment would not go through the system. With respect to salary expenses, the University had the legal obligation to make payment where an employee had performed work. However, in a recent revision to procedures, if there was need to make payment from an account with inadequate funding, the part of the payment that could not be covered from the research account - or donation account - would be made from the accounts of Department involved. It was not absorbed by central funding. Therefore the Department had an incentive to control spending from its research and donation accounts. Excepted from that control were cases where a grant had been made and the University was simply awaiting payment of an invoice from the granting agency. Before the establishment of the new controls, there had been instances of overspending from research and donation accounts, some of which still remained on the University's books.

- **Pension plan**. The calculation of the accrued obligation for employee future benefits, especially pension benefits, was highly sensitive to the assumptions used. Management, in consultation with the actuaries determined the appropriate assumptions to use (subject to the approval of the Pension Committee). The auditors, in consultation with the Ernst & Young's own actuaries, had examined those assumptions, and they had determined that they were reasonable.

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

- **New accounting standards**. The Committee had received a very good paper from Mr. Piché on the new accounting standards to be used for the 2012-13 financial statements, and the auditors had concurred with the disclosure of those changes included in note 2 to the current financial statements. Application of the new standards would include provision for the recording of the value of the University's lands as at May 1, 2012. The auditors had reviewed that valuation, and they intended to state their view that it was appropriate.

- **Restricted research grants**. Ms Tory recalled that both the auditors and the Committee had been working to gain a better understanding of controls with respect to activities funded by research grants. The auditors had been retained to complete audits of the administration of individual grants from sources other than the three major Canadian research granting agencies (the "tri-Councils," which completed their own audits); they had therefore had the opportunity to become familiar with details of administration of grant-funded activities. There was some concern about the completion of needed reporting, in part because of the absence of staff in the Faculties and Departments who had appropriate financial training to assist researchers with reporting. The central Research Oversight and Compliance Office had done excellent work on achieving improvements, but its Executive Director had recently left the University to take up a more senior position elsewhere, as had another senior person in the Office. Recruitment of the successor to the Executive Director was underway. Ms Brown observed that one important matter to be considered in the near future would be the division of responsibility between the Faculties / Departments and the central Research Compliance and Oversight Office. The Chair recalled that the Committee would, at its meeting of October 10, 2012, be considering specifically the matter of the financial administration of research grants.

Ms Tory referred members to the required communications from the auditors to the Committee, which were on pages 8 – 12 of the "Audit Results" report. She stated that there was for the current year no report on audit differences between management and the auditors because there were no such differences. She drew members' attention (a) to the letter of from the auditors verifying their independence from the University, pursuant to the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario, and (b) to management's draft letter of representation to the auditors. Finally, she asked members of the Committee and management if they knew of any matters that might have changed the approach taken by the auditors or the conclusions they reached, including any knowledge of fraud or other illegal acts. Members indicated no such knowledge.

(c) External Auditors: Private Meeting

THE COMMITTEE MOVED IN CAMERA.

4. Audited Financial Statements for the Year Ended April 30, 2012 (Cont'd)

Members of the administration, the Secretariat and the internal auditors absented themselves. Ms Tory was invited to advise, as provided in the Committee's terms of reference, of "any problems encountered by the auditors, any restrictions on their work, the co-operation received in the performance of their duties by the administration and the Internal Audit Department, and any matters requiring discussion arising from the auditors' findings."

THE COMMITTEE ENDED ITS IN CAMERA SESSION.

The Chair reported that there had been no matters arising from the Committee's *in camera* meeting with the external auditors that would require action.

(d) Legal Claims

The Chair said that the Committee's terms of reference charged it to review "in connection with the review of the University's audited financial statements, an annual report on substantial outstanding legal actions against the University in order to monitor contingent liabilities that should be disclosed in financial statements, as well as . . . to monitor possible risk exposures." The claims included in the report were for amounts that exceeded $300,000.

Mr. Piché noted two changes in the format of the annual report. First, legal claims made since the previous annual report were underscored. Second, information was provided on claims that had been removed from the previous annual report, with information on their outcome. There had been only one claim removed, with that claim discontinued by those who had initiated it without any payment in settlement of the claim. Mr. Piché responded to a question concerning one of the new claims.

It was agreed that the Committee had no concern with respect to the disclosure in note 25(c) to the financial statements concerning contingencies with respect to legal claims.

(e) Committee Recommendation

On the recommendation of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

THAT the University of Toronto audited financial statements for the fiscal year ended April 30, 2012 be approved.

On behalf of the Committee, the Chair congratulated Ms Brown and Mr. Piché and members of their staff on their very well done job in preparing the University's highly complex financial statements.

5. External Auditors: Appointment for 2012 – 13

The Chair invited the member who had taken the Committee's recommendation for the appointment of auditors to the Business Board in 2011 to comment on the discussion at that time and to comment on the issue more broadly. The member reported that there had, at the meeting of the Business Board one year previously, been a strongly articulated view that the University should open audit services to a request-for-proposals process. The objective was for the University to be beyond reproach in its selection of professional advisors. While that point of view did not imply that the Committee should support a change in the audit firm, it did mean that the Committee should be proactive in considering the suggestion that the audit be subject to a request for proposals in order to advance the comfort level in the Business Board and the Governing Council. To be proactive, it was very important that the Committee be aware of the broader context for the appointment of auditors, and the paper by the Chief Accountant of the Ontario Securities Commission, edited for the Committee and forwarded by the Chair, had been particularly helpful. In considering the matter, the Committee should bear in mind that the University's financial statements required a very complex audit. Completing such an audit successfully required expertise in auditing for not-for-profit organizations and required knowledge of the complexities of the University of Toronto. It also required the ability to work at arm's length from, but effectively and efficiently with, the University's Finance staff. That was all the more the case given the precedent of producing the financial statements on so tight a time line. The member suggested that the Committee could consider, although not necessarily approve, a policy on the appointment of external auditors, which might mandate a change of auditors after a given number of years or might mandate that the audit be put out to tender every given number of years. Such a policy might well specify a rotation between two firms so that both could maintain a sufficient knowledge base about the University to complete an audit within the current tight time-line. The member cautioned that he would not recommend change simply for the sake of change. The University was currently receiving highly expert and very good service at a reasonable cost. The partner in charge of the audit was a national leader in auditing universities and other not-for-profit organizations. It was quite likely that any change would ultimately have a cost, not only in terms of price but also in terms of the staff time required to assist a new firm in obtaining the information and understanding necessary to complete the audit. The relationship between the University's Finance staff and the current auditors was a good one but not so close as to put independence at risk. There being no issue with respect to the present appointment, the member urged that any policy change be made only after careful thought by the Committee.

The Chair observed that in the world-wide review of the appointment of external auditors, only European authorities currently supported a compulsory policy of limiting terms of audit firms or at least requiring that audits periodically be put out to tender. The Canadian review of the matter had only recently begun. Another member agreed that the University, if it were to adopt such a policy, would be on the leading edge of doing so in Canada. However, the matter was also under consideration in the United States, and it appeared entirely possible that a rotation or tendering rule might be established there within the next few years. Another member observed that such a policy might well be an expensive one not only for the corporations hiring

5. External Auditors: Appointment for 2012 – 13 (Cont'd)

auditors but also for audit firms, who would have to prepare proposals to serve as auditors for very limited terms. There might therefore be some reluctance to submit proposals for certain corporations and there might therefore be unexpected consequences of poorly considered requirements. A member observed that corporations that requested proposals for limited terms currently often did so with a fast process, expecting audit firms to submit relatively abbreviated proposals.

A thorough debate on the matter followed. In that debate, members reached two conclusions. First, the Committee should recommend the reappointment of the current auditors for the 2012-13 audit. A number of new accounting rules would be implemented for 2012-13, management had already discussed plans for implementation of those rules with the current auditors, and the parties had agreed on appropriate implementation. The University had already engaged Ernst & Young, and paid the firm, to complete certain assignments that would be integral parts of that audit. In particular, that firm had audited the University's May 1, 2011 valuation of its land, which would be included in its assets beginning in 2012-13, replacing the valuation of the land at its historic cost. Ernst & Young had also completed, or was also actively engaged in, subsidiary audits that would feed into the main audit, for example audits of capital projects and audits for the funding agencies of the implementation of certain grant-funded research projects. The University's audit was a highly complex one, and a number of related audits fed into the main audit: the audit of the pension funds, the audit of the University of Toronto Press, the University of Toronto Asset Management Corporation and others, and it would be difficult to make a change (a) without substantial lead time, and (b) at the same time as the implementation of major changes in the accounting rules. There was no need to make a change for the forthcoming year for reason of the quality of the firm's service. On the contrary, the Committee was highly satisfied that the auditors had outstanding expertise; the partner responsible for the audit was recognized as the leading national authority in accounting for universities and other not-for-profit organizations. The audit team had performed its functions very effectively and efficiently, enabling the University to issue its financial statements very soon after the end of the fiscal year and enabling review and approval of the statements by members of the Committee, Business Board and the Governing Council who had been in place during the fiscal year. The Committee was highly satisfied, through its review of Ernst & Young's detailed "Audit Results" report and through its candid, detailed *in camera* discussions with the auditors, without management present, that there was no issue of auditor independence. Finally, there were likely to be developments with respect to rules governing auditor appointments and auditor independence. It would be appropriate to defer action while observing the direction of those developments rather than acting in advance of them and possibly being required to make further changes as a result of them. Finally, there was clearly no reason to be concerned about the cost of the audit; the Committee's annual review of audit fees charged to universities across Ontario made it clear that the University was receiving auditing services at an appropriate fee as well as good value for that fee.

5. External Auditors: Appointment for 2012 – 13 (Cont'd)

Second, however, the Committee would undertake to monitor international developments and would consider the matter of appointment of auditors in the fall of 2012 so that any recommendation for change could be made (a) on the basis of fuller knowledge of international and regulatory developments, and (b) with adequate notice. The outcome could be a recommendation for a policy governing the appointment of auditors, perhaps one requiring a limited term for appointments and rotation of audit firms or partners in charge of the audit, or perhaps one requiring a periodic request for proposals but not necessarily requiring rotation. The outcome could also possibly be no change.

Ms Brown stressed that whatever the outcome of the Committee's review, it was essential from the point of view of practicality, that there be a long lead time for the introduction of any change. The University was able to produce its financial statements soon after the end of the fiscal year only because issues with respect to its accounting were dealt with by discussions with the auditors throughout the year. Therefore, the audit firm and the audit team had to be in place at, or very close to, the beginning of the fiscal year. If a new firm were to be appointed without adequate notice, the financial statements would have to be presented to the new Committee and to the new Governing Council, as they were at most other universities, in the fall.

On the recommendation of the Chief Financial Officer,

YOUR COMMITTEE RECOMMENDS

(a) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto for the fiscal year ending April 30, 2013; and

(b) THAT Ernst & Young LLP be re-appointed as external auditors of the University of Toronto pension plans for the fiscal year ending June 30, 2013.

6. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2012

Ms Brown reported that Standard and Poor's had on June 6, 2012 completed a review of the University's credit-worthiness and had maintained the University's credit rating at AA with a negative outlook. That was one full level above the credit rating of the Province of Ontario. The Dominion bond Rating Service had maintained the University's rating at AA with a stable outlook, similarly above the rating accorded to the Province. Moody's had downgraded the University's rating from Aa1 with a negative outlook to Aa2, the same rating it accorded to the Province.

Ms Brown said that her annual report on borrowing dealt with two matters. The first was the University's external borrowing capacity. That capacity, as defined by its Borrowing

Strategy was 40% of the value of its net assets averaged over the previous five years. Taking into account

6. Borrowing Capacity and Status of the Long-Term Borrowing Pool to April 30, 2012 (Cont'd)

the University's net assets as reported in the 2012 financial statements, that borrowing capacity as at April 30, 2012 was $746.6-million – a decline from the capacity as at April 30, 2011, which had been $773.1-million. That decline was problematic in that external borrowing approved for capital projects at April 30, 2012 amounted to $770.0-million, which exceeded the borrowing capacity as currently defined. The Borrowing Strategy was to be reviewed over the summer and early fall of 2012. The adoption of the new accounting rules, permitting the inclusion in assets of University land at its value as at April 30, 2012, would result in the external borrowing capacity increasing by $440-million. A review was being conducted to identify an appropriate debt strategy going forward.

The second matter dealt with in the annual report was the status of the Long-Term Borrowing Pool – the self-imposed sinking fund the University used to accumulate monies to repay its borrowing when its debenture issues become due: $160-million in 2031, $200-million in 2043; $75-million in 2045; $75-million in 2046; and $200-million in 2051. The value of the assets in the Pool amounted to $101.2-million as at April 30, 2012. The monies derived from the repayment of loans made to capital projects, and they were invested in the Long-Term Capital Appreciation Pool – the same fund as used for the investment of most of the University's endowment funds. The assets in the Borrowing Pool had therefore incurred the same substantial investment losses in 2009 as had the endowment funds. The value of the Pool's assets had since that time had begun to recover, and the condition of the Pool was reasonably satisfactory at this time.

7. Report of the Administration

Ms Brown, Mr. Charpentier and Mr. Britt reported that they knew of no matters not on the agenda that should be reported to the Audit Committee at this time.

8. Date of Next Meeting

The Chair advised members that the Committee's first regular meeting for 2011-12 was scheduled for Wednesday, October 10, 2011 at 4:00 p.m. That meeting would be devoted to consideration of a number of matters related to risk assessment. The Chair would over the summer review the Committee's calendar of business for 2012-13.

9. Internal Audit: Annual Report, 2011-12

Mr. Britt presented the Internal Audit Annual Report for 2011-12. He outlined the work completed by the Department during the year, which had been roughly consistent with the Department's plan for the year, and he outlined some of the highlights of that work.

- **Special audits / investigations**. The Department had undertaken investigations of two major matters during the year. Both had been reported to the Committee. In both cases, the

9. Internal Audit: Annual Report, 2011-12 (Cont'd)

employees involved were no longer employed by the University, and in one case the matter was being referred to the Toronto Police for criminal action.

- **Transaction compliance reviews**. The Department had continued to implement its program of reviewing a monthly sample of specific transaction types in operating, research and trust accounts. The program had previously been referred to as continuous auditing, but that term had come to take on a different meaning. A substantial number of exceptions had been found, with 53% of the transactions sampled having at least one deficiency relative to a strict interpretation of the relevant policy or administrative procedure. That outcome was similar to that in 2010-11. Most deficiencies involved incorrect coding, inaccurate calculations, absence of appropriate supporting documentation, or absence of appropriate signatures to authorize the transaction. The supporting documentation differed depending on the nature of the account. The research-granting agencies in some cases required documentation that differed from University requirements. The signatures required were those of the claimant and the person at one level up the administrative structure from the claimant. The transaction compliance reviews in 2012 had focused on expense reimbursements and accountable-advance settlements. The compliance-review program included a separate review of a sample of executive management expense claims, all of which had been in order.

- **Information systems work**. The Department's work in the information-systems area had been primarily advisory in nature. Among other things, Mr. Daniel Ottini, who had attended some meetings of the Audit Committee, was a member of two key information-technology governance committees and had participated in a number of projects.

- **Follow-up reviews**. The Internal Audit process called for follow-up reviews to be conducted between twelve and sixteen months following the issue of reports on departmental audits. The pressure of time had prevented complete adherence to that objective, but nine follow-up reviews had been undertaken, as shown in Schedule 2 to the annual report. In some cases, the actions recommended in the departmental audits had not yet been completely dealt with, not for reason of unreasonable delay but because of the need to complete substantial restructuring to deal with the recommendations, for example the need to develop tie-ins between departmental projects and central information-technology systems. The Internal Audit Department would continue to monitor those situations.

- **Accountability reports**. The internal auditors examined the completion of accountability reports in the departments that were reviewed. In those departments, 71 reports were required, and 70 had been completed. In the sole case where a report had not been completed, the faculty member had left the University before the last day for reporting.

- **Departmental audit outcomes**. As the outcome of departmental reviews, the effectiveness of Departments' internal controls and the extent of the residual risk in their administration

9. Internal Audit: Annual Report, 2011-12 (Cont'd)

was ranked in one of three categories: strong, adequate or "needs improvement." As the result of the six departmental reviews completed in 2011-12, two departments were ranked as adequate and four were ranked as needing improvement. Appendix "A" to the report listed the particular risks found in each review where mitigating controls required improvement. The risk categories used were the same as those used in the University's Risk Assessment Profile, reviewed by the Committee earlier. Those risk categories were defined in Appendix "C" to the annual report. A member expressed concern that two thirds of the departmental audits revealed that the unit's business administration needed improvement. She asked whether the Mr. Britt anticipated the same outcome for the departments in which the reports were still in draft form. Mr. Britt replied that he anticipated that the remaining departments would have rankings of strong or adequate. Had the reviews indicated a likely need for improvement, the Internal Audit Department would have given priority to completing the reports and Mr. Britt would have reported concerns to the Committee.

Mr. Britt concluded that the Internal Audit Department's work had indicated that there were, overall, no significant risks that were not being monitored or mitigated, but there was room for improvement at the divisional / departmental / functional level. That need for improvement should be addressed on a timely basis.

Among the matters that arose in discussion were the following.

(a) Audits of particular departments after follow-up reviews. A member noted that the Internal Audit Department made it a practice to complete a follow-up review in about twelve to sixteen months after the issue of an audit report. Given the highly decentralized nature of the University and the frequency of staff turnover in the divisions, how often did the Internal Audit Department return to departments after follow-up reviews for a second audit to determine whether improvements were being sustained? Mr. Britt replied that there was no structured policy for second reviews. In setting the audit plan for the next year, the Internal Audit Department took into account all information about potential risk. With respect to departments deemed to be high risk in a review, the main emphasis was given to the follow-up review to ensure that the departments' commitments were carried out.

(b) Overall risk ranking. A member referred to Mr. Britt's conclusion that "the audit results indicated the level of financial and/or operational risk is considered acceptable for the size and complexity of the University's decentralized financial environment." On the other hand, two thirds of the departmental audits revealed that the units needed improvement. Mr. Britt replied that on the level of the institution overall, he considered the level of risk to be satisfactory. In certain individual units that had been selected for audit, which were selected in many cases because of concerns about potential risks, there was need for improvement. He agreed with the member's observation that his University-wide risk assessment was based on resources that

9. Internal Audit: Annual Report, 2011-12 (Cont'd)

limited the number of reviews that would, in better circumstances, be appropriate. Mr. Britt also observed that the year had been an unusual one in terms of the high proportion of "needs improvement" reviews.

(c) Frequency of departmental reviews. A member observed that, because of limited resources, the Internal Audit Department sought to focus its reviews on potential high-risk areas rather than following a regular cycle of reviews of all departments. Mr. Britt agreed. There were about 400 auditable units in the University, and it was not possible to visit even all potentially high-risk areas as frequently as desirable.

(d) Process for follow-up reviews. In response to a question, Mr. Britt said that at about six months after the issue of a report, the Internal Audit Department issued a request for an update. Divisions or departments provided a report on their actions in response to the audit report and on any continuing issues. That was followed by discussions with the division / department and by efforts to assist the unit in achieving implementation of audit recommendations. In response to a further question, Mr. Britt said the Internal Audit Department subsequently reviewed the units on a test basis to determine whether they had implemented the recommendations.

10. Internal Audit Plan, 2012-13

Mr. Britt presented the Internal Audit Plan for 2012-13. The plan projected 8,500 direct audit hours from a full-time-equivalent staff complement of 7.5. He noted that all members of the Internal Audit staff had earned professional designations as accountants or auditors – a fact that provided assurance of high-quality audit work. In response to a member's question about audit hours, Mr. Britt said that the number of staff hours available for direct auditing assignments had to be reduced pursuant to the University's vacation policy and Christmas closing. Thereafter, time had to allowed for general and administrative functions. Audit Managers were expected to devote between 50% and 60% of their time directly to audit assignments and other staff were expected to devote 80% to 90% of their time to such assignments.

Among the highlights of the Internal Audit Plan were the following.

- **Objectives**. The Department sought to draw to the attention of management and the Audit Committee to any significant, unmitigated operational and financial risks and to provide an evaluation of the effectiveness of the mitigating controls and risk-management practices as stated in the University's Risk-Assessment Profile. The Department would test compliance with policies, procedures, contracts and applicable statutory and regulatory requirements and the safeguarding of assets. Testing compliance with contracts and regulatory requirements was particularly stressed in the review of funded research projects, where such compliance was very important to the funding agencies and contracting parties. Finally, the department played an advisory role in the development and implementation of effective administrative policies and procedures.

10. Internal Audit Plan, 2012-13 (Cont'd)

- **Scope of Internal Audit services**. Services included:

  - assurance services (previously called departmental audits);
  - reviews of information-technology systems, projects and changes, data-integrity controls, and provision of advisory services in this area;
  - transaction compliance reviews (previously called continuous auditing);
  - assistance to the external auditors with the audit of the annual financial statements;
  - follow-up reviews;
  - investigations; and
  - advisory services.

  Mr. Britt showed the time allocated to each area in the plan, and he compared that time to the actual time spent on the area in the 2011-12 year. The planned allocation of 8,500 hours to audit services in 2012-13 represented a 16% increase from the hours provided in 2011-12 – an increase that would be achievable with the availability of the full staff complement over the year.

- **Process for developing the Internal Audit Plan**. In compiling the Internal Audit Plan, Mr. Britt had undertaken extensive consultations with the University's senior management. All of the individuals consulted had been very cooperative and helpful in making suggestions for inclusions in the Plan. Mr. Britt had had sought to align the plan with the University's Risk-Assessment Profile. All suggestions had then been assessed to determine the highest-priority risks and processes, and the Plan had been drawn up based on the potential impact of audits on the achievement of University objectives and based on the likelihood of internal-control or process issues. The risks and risk-mitigation activities in the Plan had been identified based on the areas defined in the Risk Assessment Profile.

Mr. Britt commented on the specific areas for review selected for the 2012-13 Plan. He thought that the Plan was a particularly robust one, having benefited greatly from the input from members of senior management. The Department continued to receive calls from several units requesting audits, including some that had not been heard from previously. Those units clearly had seen the advantage of an independent, expert examination of their business operations.

11. Internal Auditor: Private Meeting

THE COMMITTEE MOVED IN CAMERA.

Members of the administration, the Secretariat and the external auditors absented themselves. The Committee met privately with the Director of the Internal Audit Department. Mr. Britt was invited, as provided in the terms of reference, to report on "any problems

11. Internal Auditor: Private Meeting (Cont'd)

encountered, any failure to provide appropriate information or any restrictions on internal audit work, the general cooperation received in the performance of internal audit duties, and any matters requiring discussion arising from the auditor's findings.

THE COMMITTEE CONCLUDED ITS IN CAMERA SESSION.

The meeting adjourned at 7:20 p.m.

Secretary

Chair

July 12, 2012