UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 82 OF THE AUDIT COMMITTEE

June 21, 2006

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, June 21, 2006 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Ms Paulette L. Kennedy (In the Chair)
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. Richard Nunn
Mr. David Oxtoby
Mr. Roger P. Parkinson
Professor Gordon Richardson
Mr. Robert S. Weiss

Ms Catherine J. Riggall, Vice-President, Business Affairs *
Mr. Mark L. Britt, Director, Internal Audit Department ***
Ms Sheila Brown, Chief Financial Officer *
Mr. Louis R. Charpentier, Secretary of the Governing Council *

Secretariat:

Mr. Neil Dobbs *
Ms Cristina Oke *

Regrets:

Ms Dominique Barker
Mr. George E. Myhal
Mr. Christopher Sparks
Mr. Mark Weisdorf

In Attendance:

Ms Jacqueline Orange, member of the Governing Council and Chair, Business Board
Mr. Pierre Piché, Controller and Director of Financial Services *
Ms Martha Tory, Ernst & Young **

ITEMS 1 AND 2 CONTAIN RECOMMENDATIONS TO THE BUSINESS BOARD FOR APPROVAL.

* Absented themselves for the Committee's consideration of item 1 (d), External Auditors: *In Camera* Meeting, and item 5 Internal Auditor: Private Meeting.

** Absented herself for the Committee's consideration of item 2, External Auditors: Appointment for 2006 – 07, and item 5 Internal Auditor: Private Meeting.

*** Absented himself for the Committee's consideration of item 1 (d), External Auditors: *In Camera* Meeting.

1. Audited Financial Statements for the Year ended April 30th, 2006

(a) Presentation

Ms Brown thanked Mr. Piché and his colleagues in the Financial Services Department, the divisions and departments, the Internal Audit Department and the external auditors, all of whom had once again completed the financial statements immediately after the close of the fiscal year. The statements had been audited and the audit report was a clean one*. Ms Brown noted that the *Financial Report* for 2005-06 had been issued in a different format from that of previous years. The document would be available on the University's website. A small number of printed copies would be prepared for institutional reporting purposes.

Mr. Piché presented the financial statements using a PowerPoint presentation. The key points of the presentation included the following.

- **Contents of the financial statements.** The University's financial statements for 2005-06 included all operations under the jurisdiction of the Governing Council, as well as four controlled, separately incorporated entities with boards of directors, including the University of Toronto Press Inc., the Innovations Foundation, the University of Toronto Asset Management Corporation (UTAM), and the University of Toronto Schools (UTS). The Financial Statements did not include the federated universities and the research administered at the affiliated teaching hospitals.

- **Key components of net assets (assets minus liabilities)**. There were four key components of the University's net assets. Endowments were unique to not-for-profit institutions. The sum of the other three elements was the same as the retained earnings of for-profit businesses.

  - **Endowments**. These were endowed contributions plus reinvested investment earnings, recorded at fair values. Endowed donations could not be spent, and investment earnings could be spent only for the purposes specified by the donors to the endowment.

  - **Investment in capital assets**. These were retained earnings that had been invested in capital assets. The recorded amount of the investment was reduced over time to match the amortization of capital assets.

  - **Internally restricted net assets**. These retained earnings were committed to be spent for specific purposes in future. As detailed and described in note 13 to the financial statements, these included departmental trust funds, unexpended operating funds such as net divisional carryforwards and employee future benefits, and monies set aside for the Supplemental Retirement Agreement (SRA).

  - **Unrestricted deficit**. This was the University's negative retained earnings and represented its cumulative deficit.

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* The unqualified audit opinion was subject to approval of the financial statements by the Governing Council.

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(a) Presentation (Cont'd)

- **Significant accounting concepts: Revenue and expense**. Mr. Piché stressed that the revenue recorded in the financial statements was not the same as funds received, and expense was not the same as funds spent. Revenues included restricted and unrestricted funds.

  - Unrestricted grants and expendable donations were recorded as revenues when received.
  - Restricted grants and expendable donations were recorded as revenue when spent.
  - Unspent restricted grants and expendable donations were recorded as liabilities – deferred contributions.
  - Endowed donations and investment earnings on externally restricted endowments were not recorded as revenue at all, but were added directly to endowments on the balance sheet.

  Expenses incorporated non-cash items including the amortization of capital projects. Restricted contributions to be spent on capital assets were initially recorded as a liability – deferred capital contributions – and the liability was reduced when the asset was amortized. A second significant non-cash expense was the recording of the estimated cost of employee future benefits earned for employees' service in the current year, as required by the accounting rules.

- **Significant accounting concepts: Fund accounting.** Internally, the University recorded its financial transactions using fund accounting. There were four funds:

  - **Restricted funds**: donations, including endowments, and research grants.
  - **Capital fund**: spending on capital projects, except those for ancillary operations. The amortization of capital assets was recorded in the capital fund.
  - **Ancillary operations** including: residences, food and beverage services, parking, Hart House, Real Estate Division, University of Toronto Press, and, for its final year as an ancillary operation, the University of Toronto Innovations Foundation.
  - **Operating fund**: teaching and administrative activities supported mainly by government operating grants, student fees, and sales of supplies and services – in short all operations not included in the other funds.

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(a) Presentation (Cont'd)

- **Key drivers of financial performance**. The growth of student enrolment had brought about increased revenue but also the increased expense required to provide teaching and services to the additional students. The growth in research activity had been funded by increased revenue from research grants, but it had also caused increased direct expense to carry out the research work as well as only partially funded increases in indirect or overhead costs. The growth in research activity had also required an increase in space. The growth in the cost of salaries and benefits had been driven in part by increases in enrolment, requiring the engagement of more faculty and staff. It had also been driven by the increase of research activity, which had also required the engagement of more staff. Growth requiring new space had also required increased borrowing and had driven up interest expense. Donations had increased either revenue or the balance in the endowment. The growth in the endowments had provided additional income to spend on the objectives of the various endowment funds. Investment earnings were highly variable from year to year, and the amount of investment earnings was often the key factor in determining whether the University had net income or a net loss. Investment earnings on the endowment funds beyond the annual payout increased the size of the overall endowment. Clearly, all of the key drivers of financial performance were highly inter-dependent.

- **Financial results: Assets, liabilities and net assets**. Both assets and net assets had grown substantially over the past four years. The University's assets as at April 30, 2006 amounted to $3.7-billion. Subtracting liabilities of $0.9-billion and deferred contributions of $0.9-billion, net assets were $1.9-billion. Net assets had increased by $240.3-million over the year because of an increase in the endowments, in internally restricted funds and in investment in capital assets. The endowment had been growing steadily in value over the past four years. It had increased in value by $206.0 million over the past year to $1.6-billion. It represented 86.8% of the University's net assets. The investment in capital assets had increased by $17.5-million to $283.9-million. In addition, the internally restricted funds had grown by $43.1-million to $134.8-million, with increases in departmental funds and in the amount set aside by the University for the Supplemental Retirement Arrangement. Those increases were offset by an increase of $26.3-million in the unrestricted deficit to $171.1-million, mainly generated by the need to set aside retained earnings for internally funded capital assets.

  The income sources of the $240.3-million addition to net assets were: net income of $75-million, the investment gain on externally restricted endowments of $119.5-million, externally endowed donations of $37.9-million and externally endowed grants from the Government of Ontario of $7.9-million. The primary source of income for the increase was good investment performance.

- **Financial results: endowments**. The capital of the endowment funds could not be spent. As noted, the endowment had increased by $206-million to $1.6-billion. The

1. **Audited Financial Statements for the Year ended April 30th, 2006** (Cont'd)

(a) Presentation (Cont'd)

increase had arisen from $146.3-million of investment earnings above the payout, $45.8-million of donations and grants, and $13.9-million of transfers from expendable funds to match donations. Nearly $700-million of the endowment, or 42.9%, was devoted to generating income for student aid. $507-million supported endowed chairs and professorships, $232.8-million supported research activities, and $189.0-million supported academic programs.

- **Financial results: revenues and expenses**. The University's revenue had been growing in recent years because of the growth in student enrolment and in research activity. Expenses had been growing primarily because of growth in the cost of salaries and benefits and also because of inflationary growth in other expenses. For 2005-06, revenues had amounted to $1.8-billion and expenses had amounted to $1.7-billion. Net income for the year was $75-million, the third consecutive year of positive net income following three years of losses.

- **Financial results: sources of revenue**. Since 1999, the University's revenue had grown primarily because of the growth in student enrolment and increases in the volume of research. Of the $1.8-billion of revenue for 2005-06, about $590-million had come from government grants, an increase from $553-million in the previous year. The previous year's grant included a one-time $26-million grant for facilities-renewal made at the end of the Government's fiscal year. The increase in 2005-06 over the previous year reflected special grants made primarily in response to the University's enrolment increase. The special grants included $12.6-million for undergraduate accessibility, $16.4-million for quality improvements, $6.9-million for the Access to Opportunities Program (an expansion of enrolment in high demand areas including engineering and computer science) as well as $13.5-million to compensate for the cost of the tuition-fee freeze. There had been no special end-of-year grant for facilities renewal in 2005-06. Revenue from student fees had increased from $472-million to $506-million. That reflected an increase in enrolment from 57,887 full-time-equivalent students in 2004-05 to 60,203 full-time-equivalent students in 2005-06. While tuition fees for most programs were frozen for domestic students, they had increased for international students, with the fee increase and enrolment increase together improving revenues by $17-million. Investment income had also increased substantially from $83-million in 2004-05 to $120-million in 2005-06, reflecting good investment performance.

- **Financial results: Government and other grants and contracts for restricted purposes**. The University had received $356.4-million in research grants and contracts and in grants for capital infrastructure and other restricted purposes for 2005-06. Of that amount, $332.2-million had been recorded as revenue, compared to $302.4-million in 2004-05. The unspent amount of research grants was not yet recorded as revenue but rather as a liability – a deferred contribution – and the undepreciated amount of capital grants was also recorded as a liability – deferred capital contributions. In the absence of

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(a) Presentation (Cont'd)

the special capital grant from the Province, the total grants for capital infrastructure and other capital grants had declined from $34.3-million in 2004-05 to $12.2-million in 2005-06. Restricted grants for research had remained relatively flat year over year, at $346.9-million in 2004-05 and $344.2-million in 2005-06. The total amount of research grants and contracts had, however, been increasing markedly over the past eight years, reflecting both Canada's stronger research agenda and the success of University of Toronto scientists and scholars in winning a disproportionate share of research funding.

- **Financial results: Donations received**. Over the past four years, donations received by the University had amounted to an average of nearly $80-million per year, an impressive amount for years in which the University was not engaging in a formal fundraising campaign. For 2005-06, the University had received donations amounting to $74.9-million, of which $37.9-million had been added to the endowment and $37.0-million had been reported as revenue. Those amounts did not include pledges that had not yet been fulfilled and also did not include funds that had been raised for the federated universities.

- **Financial results: Investment earnings**. Investment earnings for the year had been $239.5-million. The earnings on endowed funds had enabled a payout of $54.0-million to the beneficiaries of the endowments, a replenishment of the capital of externally restricted endowments of $119.5-million, and a replenishment of the capital of internally restricted endowments of $26.8-million. Over the past three years, investment earnings had been sufficient to provide the payout and to replenish the capital that had been used for payouts in the three years from 2000-01 to 2002-03, when the investments had lost money. The return on the Long-Term Capital Appreciation Pool – the investment vehicle for almost all of the endowments – had been 15.8%, compared to the benchmark return of 16.2% (the benchmark was a weighed average of various securities index returns). In addition, the University had earned $39.2-million on its expendable funds, including the amount set aside for the Supplemental Retirement Arrangement and the Long-Term Borrowing Pool, both of which were invested (along with the endowments) in the Long-Term Capital Appreciation Pool.

- **Expenses**. Total expenses for 2005-06 had been $1.709-billion, an increase from $1.613-billion in the previous year. Significant changes included an increase in spending on repairs and maintenance, from $48.8-million to $54.2-million, reflecting an increase in the maintenance work completed. Spending on utilities had increased from $44.5-million to $51.1-million, reflecting the increase in the cost of utilities. The most significant increase, however, had been in expense for salaries and benefits, which had increased from $936.3-million to $1,012-million.

- **Expenses: Salaries and benefits**. Benefits expense had increased from $33.3-million in 1998-99 to $202.8-million in 2005-06. The primary reason for the increase was the increased cost of providing pensions and other employee future benefits. Those were

1. **Audited Financial Statements for the Year ended April 30th, 2006** (Cont'd)

(a) Presentation (Cont'd)

benefits earned by employees in the current year to be paid in the future. Since 2001, those expenses had been recorded on an accrual basis rather than pay-as-you-go, and the expense included the addition of past service liabilities as at 2001, which were being recorded over 14 years. The $202.8-million benefits expense for 2005-06 included employee future benefits expense of $123.7-million as well as other benefits expense of $79.1-million. Salary expense had increased from $502.8-million in 1998-99 to $809.5-million in 2005-06. In part, the rise in cost reflected salary increases, which averaged approximately 4.5% per employee, including both across-the-board increases and progress-through-the ranks / merit increases, bringing salary expense from $502.8-million in 1998-99 to $684.0-million in 2005-06. In part it reflected an almost 19% increase in the number of employees, reflecting the growth in student enrolment and research activity over those years. Salary increases accounted for $181-million of the $307-million cost increase, whereas increases in the number of employees accounted for $125-million of the cost increase.

- **Expenses: Capital investment in infrastructure**. The University's building program had been required to support its growth in student enrolment and in research activity. The amount of spending on construction had, however, been in a downward trend for the past three years. Capital spending had peaked at $329.3-million in 2003-04, and it had declined to $268.0-million in 2004-05 and to $216.7-million in 2005-06. Depreciation expense had grown, reaching $91.4-million in 2005-06. The $216.7-million of investment in capital assets in 2005-06 included $39.6-million to acquire equipment and $21.1-million to purchase library books. Spending on construction projects included: $21.4-million of spending on the Terrence Donnelly Centre for Cellular and Biomolecular Research (representing 41% of the total project cost), $20.6-million on renovating the Health Sciences Building at 155 College Street (the former Toronto District School Board building), $19.3-million on the Leslie Dan Pharmacy Building (representing 36% of the total project cost), $16.4-million on the University of Toronto at Mississauga (UTM) Academic Learning Centre, $11.1-million on the UTM Wellness Centre, and $27.9-million on the University College Morrison Hall residence building.

- **External borrowing outstanding**. Borrowing as at April 30, 2006 amounted to $483.7-million, which included the $75-million series "C" debenture issued in November 2005. The annual report on the University's borrowing strategy appeared later on the agenda. The increase in the University's net assets had the effect of increasing borrowing capacity, which was defined as a proportion of net assets.

(b) Discussion

Ms Riggall, Ms Brown and Mr. Piché responded to numerous questions. Among the more general matters that arose in discussion were the following.

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(b) Discussion (Cont'd)

(i) De facto liabilities not recorded on the balance sheet. A member observed that the University had two liabilities that were not fully taken into account on its balance sheet; employee future benefits were not fully recorded and deferred maintenance was not recorded at all. The University's real net assets were therefore significantly less than the $1.88-billion indicated on the financial statements.

With respect to employee future benefits, Mr. Piché recalled that the accounting rules had changed in 2001, requiring that the cost of employee future benefits be accrued each year rather than being accounted for as they were paid. As a result of the rule change, the full accrued liability for benefits earned in the years before 2001 was being added to the total liabilities on the balance sheet over fourteen years. Ms Brown added that, according to the accounting rules, the liability had to be discounted to its present value using current long-term bond rates, which had been exceptionally low in recent years, with on advance recognition of an equity risk premium. Therefore, the actual situation was expected to be considerably better over the long term than it appeared from the $689-million deficit for employee future benefits, including pension benefits, shown in the *Financial Report*.

With respect to deferred maintenance, the term was used in a manner that was consistent with other Ontario universities. It was useful to calculate the number and to show to the Government of Ontario the cost of all maintenance work that was required. Some of the work was required and pending; other items could reasonably be delayed. A member said that it was important that the reader of the *Financial Report* know what the immediate requirements were and what amount of the work could be deferred. Ms Riggall replied that the annual report on deferred maintenance provided information about timing of the University's needs, classifying work needed within one, two and five years. A member noted that the operating budget did include an item for deferred maintenance and facilities renewal. Ms Riggall said that the appropriation was currently $12-million per year, an increase from only $3-million per year four years ago, which had been truly inadequate. That amount included some renovation work and some mandated work such as asbestos removal. While additional funds could always be put to use, some problems were being remedied. It was unlikely that the total cost of deferred maintenance would decline significantly even with the completion of $12-million of work each year. The University was adding new buildings, and all of its buildings were growing older. In addition, costs for maintenance and facilities-renewal work were increasing.

A member observed that the amounts required for employee future benefits, however it was calculated, and the amount required for deferred maintenance, were real liabilities. Should they be disclosed in the notes as contingent liabilities? Ms Tory replied that maintenance work was being properly expensed when completed. Capital projects to deal with deferred maintenance issues were accounted for in the same way as other capital projects, and the projects were recorded at cost and amortized over time. The full accrued cost of previously earned employee future benefits was being brought into the overall liabilities as required by the accounting rules, which could change in the future.

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(b) Discussion (Cont'd)

(ii) Indirect costs of research. A member referred to the statement on page 13 of the *Financial Report* that the amounts of research revenues received "do not adequately cover the actual costs when indirect overheads are taken into account." Ms Riggall and Ms Brown replied that research grants covered only such direct research costs as materials and laboratory staff. They did not cover such overhead costs as heating, lighting and cleaning of space, library, computer and administrative support, and the salaries of the faculty researchers. The Government of Canada had in recent years recognized the problem and had provided universities with a grant amounting to about 20% of federal research funding to cover overhead costs. In fact, the grant for the University of Toronto amounted to less than 20%, with the Government assuming that the University could achieve economies of scale. The extent of actual costs was, however, much greater. In the U.S., funding agencies often provided indirect-cost grants of between 50% and 100% of the direct research grants. The University was, as a realistic objective, asking that the Government of Canada increase its grant to 40% of direct costs. A member noted that the improvement of funding for the indirect costs of research was at the top of the list of the University's advocacy priorities.

(iii) Endowment funds. A member observed that the *Financial Report* stated (on page 20) that "the amount reinvested to preserve capital and to provide a cushion against poor investment returns was $146.3-million for 2006." Was that amount sufficient after taking into account both the effects of inflation and of losses in some earlier years? Mr. Piché replied that the amount of the cushion would be reported in the annual report on the endowment. He estimated that the allocation would in fact be sufficient to provide for a small on-going cushion. He noted that the investment return on the endowment funds invested in the Long-Term Capital Appreciation Pool had been 15.2% for the 2005-06 fiscal year.

(iv) Employee-future-benefits costs. In response to questions, Mr. Piché said that in the years prior to 2002, good investment returns meant that the University had pension income that partly offset the employee-future-benefits expense incurred when those costs had been expensed on a pay-as-you-go basis.

(v) Matching funds program. A member noted that Supplementary Schedule 3 (page 60) reported a $33.6-million deficit in the University's Matching Funds Program. Mr. Piché said that the University had had to borrow $33.6-million to honour commitments to match donations to the endowment and to certain capital purposes. The University had made provision for its repayment.

(c) External Auditors' Audit Results

Ms Tory commented on Ernst and Young's Report on the "Audit Results for the Year Ended April 30, 2006." The external auditors' opinion on the financial statements had been unqualified. The Report contained the required communications to the Audit Committee as well as other best-practice communications. Pages 5 – 6 contained the auditors' comments on the accounting for certain unusual items and transactions of audit significance.

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(c) External Auditors' Audit Results (Cont'd)

A member referred to the external auditors report of "significant audit adjustments and unadjusted differences considered by management to be immaterial." Mr. Piché replied that management had decided to adjust the draft financial statements to include an approximately $1-million accrual that had not been properly set up by one of the divisions. Ms Tory added that management had questioned the amount of the accrual with the division before the problem was discovered. When it was discovered to be a problem, management had decided to make the correction to the financial statements although such a correction would not have been required because the error was well under the level of materiality. In response to a question, Ms Tory said that the auditors had determined that the level of materiality was $15-million. The absolute dollar amount had been used rather than a percent of revenue; as the University's revenues had grown, the percent of revenue deemed to be material had declined.

Ms Tory said that she was required to obtain confirmation from the Audit Committee that it was aware of no acts of fraud or other matters of concern that had not come to the attention of the external auditors. The Chair, with the concurrence of the Committee, stated that the Committee was aware of no such matters.

Ms Tory said that the external auditors agreed with Ms Brown's statement that Mr. Piché and his staff had done an extraordinarily good job in preparing the financial statements. They were well organized and well prepared for the audit. They had prepared a good draft of the financial statements very soon after the end of the fiscal year. Their work had set a very high standard.

(d) External Auditors: *In Camera* Meeting

The Chair recalled that the Committee met at least annually with the external auditors, with no members of the administration, the Secretariat, or the Internal Audit Department present. During that meeting, the external auditors were invited, as provided in the Committee's terms of reference, (a) to advise "whether adequate cooperation has been received from [the] administration and whether [the] administration 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 MOVED *IN CAMERA*.

The Committee met privately with the external auditor.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

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

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(e) Legal Services and Claims

The Chair said that the Committee's proposed revised terms of reference charged the Committee 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."

Ms Brown said that the administration wrote to all of the legal counsel, internal and external, who acted for the University to identify actual or potential legal claims against the University, to obtain legal counsels' comments on the merits of the claims and on the strength of the University's defence against the claims. That correspondence provided the basis of note 21(b) to the financial statements: contingencies - legal claims or prospective legal claims. The correspondence was provided to the external auditors for their review. All claims exceeding $300,000 and the evaluations of their merit and the strength of the University's defence were summarized in the report now before the Committee.

Among the matters that arose in discussion were the following. In the course of discussion, Ms Riggall and Mr. Piché provided additional information about certain claims.

(i) Evaluation of contingent liability. A member said that he found it difficult from the report to assess the risk to the University from each claim. The comments on the strength of the University's defence, for example, were too general in nature to enable an evaluation. He asked for an estimate of the amount of money at risk. He also asked whether action was taken by the University in cases where there were legitimate claims arising from errors or omissions by University employees. Ms Brown replied that only the three legal actions that were underscored in the report had been launched in the previous year. Many of the others were long-standing claims that the plaintiffs had not recently pursued. The University had been advised simply to let the claims remain on the report rather than to risk provoking further action. Mr. Piché added that the language used to evaluate the merit of claims and the strength of the University's defenses was that supplied by the legal counsel in each case.

(ii) Legal actions arising from construction activities. Ms Riggall responded to questions about construction lien claims and actions by two contractors who were expected to submit claims for delay to the University. Actions had been initiated by both contractors and subcontractors. In one case, the action was being taken with respect to a building other than a University building but one where the University held a mortgage. The two anticipated claims concerned disputes about responsibility for delays and requirements for changes. All claims had been studied carefully, and Ms Riggall anticipated no serious problems arising from them.

(iii) External auditors' review and revised note. The Chair recalled that the external auditors had reviewed full information on legal claims and were satisfied with the note disclosure. She asked whether the report to the Audit Committee provided a typical level of information to audit committees. Ms Tory replied that typically no such report was provided; the University's

1. Audited Financial Statements for the Year ended April 30th, 2006 (Cont'd)

(e) Legal Services and Claims (Cont'd)

practice was a very good one. She commented that the wording of the note had changed since the previous year. The previous disclosure of pending litigation stated that "the University believes it has valid defenses and appropriate insurance coverage in place" and that "such claims are not expected to have a material impact on the University's financial position." The 2006 note added that "There also exist other claims or potential claims where the ultimate outcome cannot be determined at this time. Any additional losses related to claims would be recorded in the year during which the liability is determinable or adjustments to the amount recorded are determined to be required." In response to a question, Ms Tory said that the University had not set aside any amount in a reserve for legal claims.

(iv) Insurance coverage. A member observed that the University had insurance coverage that would apply in the case of an adverse outcome of some claims but had no such insurance in other cases. Ms Brown said that the University purchased coverage in areas where it was available.

(f) 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, 2006 be approved.

The Chair congratulated Ms Riggall, Ms Brown, Mr. Piché, Mr. Britt, Ms Tory and all of the members of their teams on their work in producing an excellent *Financial Report* in record time.

2. External Auditors: Appointment for 2006 – 07

Ms Brown recommended the re-appointment of Ernst & Young as the external auditors for the University and for the pension fund. The administration had been very pleased with the firm's services and it was particularly pleased that Ms Martha Tory was assigned to the University's account. She was a recognized authority on accounting for the higher education sector. In response to questions, Ms Brown recalled that Ms Tory had assumed responsibility for the University's audit about thirteen months previously, following the sudden departure of the previous partner, who had retired to avoid a possible conflict of interest arising from his daughter's appointment to a client firm. The University's Purchasing Policy required a review of on-going central consulting and professional services approximately every five years. That review had taken place two years ago. To prevent too close a relationship between the auditors and the entity being audited, Ernst & Young provided for partner rotation for its accounts, including the University's account. The Sarbanes-Oxley Act in the U.S. required partner rotation

2. External Auditors: Appointment for 2006 – 07 (Cont'd)

every five years. The U.S. National Association of College and University Business Officers had taken the view that partner rotation every five years was too frequent for the post-secondary education sector, which had a number of specialized accounting rules. Its recommendation was for partner rotation at least every seven years, which the administration regarded as a best practice.

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, 2007; 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, 2007.

THE FOLLOWING ITEMS ARE REPORTED TO THE BUSINESS BOARD FOR INFORMATION.

3. Internal Audit: Annual Report, 2005-06

Mr. Britt presented the annual report of the Internal Audit Department for 2005-06. The highlights of his report included the following matters.

- **Reviews**. The Department had identified for review areas of high or medium operational or business risk, based on its risk-assessment methodology. A total of 27 departmental audits had been completed or were in progress as at the April 30 fiscal year-end. In addition, the Department had completed two quarters of continuous auditing – reviews of selected types of transactions in all units. Any concerns identified in the continuous audit process were followed up. Work on the continuous audit program had been set back by the departure of a staff auditor. Five special reviews had been commenced at the request of management. That such requests were received demonstrated management confidence in the Department. Fortunately, no special reviews had been required during the year arising from allegations of improper behaviour. Two other special reviews had been taken to follow up matters that had come to light during the continuous audit program. Those reviews, which had dealt with purchasing and the award of contracts, had led to recommendations to improve processes. Finally four follow-up reviews had been completed and seven others were in progress. Mr. Britt noted that the Department had not been able to complete its full audit plan owing to staff turnover; it would be very important to work towards completion of the plan once a vacant staff position was filled.

3. Internal Audit: Annual Report, 2005-06

- **Conclusions arising from the year's reviews**. A number of residual risks were listed in the report. In all cases, Mr. Britt and his colleagues had worked with the management of the units, and he was confident from their responses that actions would be taken to rectify problems. The outcome would become clear during the follow-up reviews that concluded the process.

- **Administrative accountability reports**. With a larger sample size, there had been an improved rate of submission of administrative accountability reports among the units that had been reviewed in 2005-06. There continued to be some interpretative issues. Staff members questioned the classification of positions as including administrative and financial responsibility and asked what level of such responsibility merited the submission of accountability reports. He and Ms Brown were continuing to work on the matter, and they continued to stress the importance of the reports in training sessions.

- **Executive expense reimbursement reports** had been reviewed through the continuous audit process. For 2005-06, $75,000 of reports had been sampled with no issue arising. All expenses had been appropriate and properly authorized by the officer at one level up.

- **Internal Audit Department staffing**. The Department had during the year lost two senior auditors and the audit/administrative assistant, and one senior auditor position remained unfilled. Retention and recruitment had proven difficult in a highly competitive environment with substantial incentives being offered to internal auditors by the private sector. Among the expedients that had been considered to assist with recruitment was offering signing bonuses and paying referral fees.

- **UTAM auditing**. The Department provided internal auditing for the University of Toronto Asset Management Corporation on a cost-recovery basis, with UTAM paying the cost of a senior auditor who worked four days per week for ten months per year as well as paying for the cost of Mr. Britt's work with respect to UTAM. The senior auditor, who had previously worked at Ernst & Young, was a highly trained individual with considerable experience auditing in the investment industry. Mr. Britt reported to the UTAM Audit and Compliance Committee. The audit reviews had found no real issues. UTAM had recently undergone a major staff reorganization and a change in its business model (ending internal management of certain types of securities and also commencing the use of external services for performance and attribution measurement). The senior auditor was working with UTAM's Manager, Compliance to review and document the significant new business processes. In response to a question, Mr. Britt said that UTAM had indicated a high level of satisfaction with the internal audit process and the value added by it.

- **Other departmental activities**. Mr. Britt referred members to a list of other activities completed by himself and members of the Department. Those activities

3. Internal Audit: Annual Report, 2005-06 (Cont'd)

were valuable in that many of them involved Internal Audit staff at an early stage of the development of policies and procedures, and they fostered professional development and therefore aided recruitment.

Among the matters that arose in discussion were the following.

(a) Persistence of residual risks. The Chair noted that although Mr. Britt expressed confidence that management in the budget units would deal with residual risks, and while follow-up reviews usually showed that management had done so, nonetheless, many of the same residual risks appeared repeatedly on the Internal Audit annual and semi-annual reports.

Mr. Britt replied that management of the University was highly decentralized, with approximately 350 auditable units, and internal controls were managed at the level of each of those units. While many of the residual risks appeared repeatedly, they did not appear in the same units. That might indicate the need for greater central direction. On the other hand, the decisions taken often involved a great deal of discretion on the part of each unit's management. When problems were identified in an audit, however, Mr. Britt did not find recurrence in the same division. Mr. Britt stressed that while the business risks reviewed in the audits were consistent with those used in the University's risk-assessment profile, the sum of the outcome of the reviews did not represent a University-wide risk evaluation.

The Chair asked if there was need for an increase in central activity to avoid recurrence of the same control weaknesses in different divisions. Mr. Britt agreed that there might well be a need for more central direction with respect to the need for compliance with appropriate practices. That having been said, in many cases the problem was not lack of knowledge but rather the application of judgement, especially in decisions about payments to individuals as contractors rather than employees.

Ms Brown said that there was extensive guidance to unit managers on the web, and there were courses available for administrative staff. With respect to compliance with income tax requirements for payments to individuals, the area was a gray one, and individuals often exerted considerable pressure to be paid as contractors. The central administration took the position that in the case of any doubt, individuals should be paid as employees. While incorrect decisions had been made in some cases, many others were far from clear, in a realm where even court rulings had not set unambiguous precedents. In response to the Chair's question, Ms Brown said that it was her understanding that University's liability in any cases that were handled inappropriately would be payments of employer and employee contributions for the Canada Pension Plan and the Employment Insurance program.

A member asked Mr. Britt if he was satisfied that there were no cases of intentional violation of appropriate procedures. Mr. Britt replied that in many cases, there was no deliberate misbehaviour. In cases where the matter was clearer, Mr. Britt would make the head of the unit aware of the matter as well as the individual to whom the head of the budget unit reported. The problem had then invariably been corrected.

3. Internal Audit: Annual Report, 2005-06 (Cont'd)

A member stated that failure to follow appropriate procedures should be factored into performance assessments. Another member said that members of the Committee had for some years stressed the importance of making clear that there would be consequences for intentional failure to follow appropriate procedures and for failure to submit accountability reports. The Committee should, while recognizing the challenges of achieving compliance in a decentralized environment, make it clear that it expected the central administration to impose consequences when appropriate. Ms Brown said that the Vice-President, Human Resources and Equity was aware of the matter and actively working on it. The Chair instructed that a follow-up report on the matter be presented to the Committee at an early date.

(b) Internal Audit Department staffing. A member observed that it was important that the University deal with the staffing problems that had been an almost constant factor in the Internal Audit Department. It was, for example, unacceptable that only two quarters' continuous audits had been completed. Another member noted that it was clearly the case that well qualified, trained and talented staff members from the Department were being recruited by other departments. There was therefore need for a human-resources plan: either to improve the position classifications for internal audit staff to promote their retention in the department or to enlarge the staff of the department to keep it at an acceptable complement despite turnover.

Mr. Britt agreed that the matter of staffing was his most significant challenge and one that went to the heart of the delivery of internal audit services and to the level of assurance his Department was able to provide. The University had been highly supportive in its consideration of the staffing needs of the Internal Audit Department. The Department had not been required to make the five percent budget reduction required of all departments over the past year. Given the financial situation of the University, that was not a decision that had been taken lightly. The Vice-President, Human Resources and Equity was also fully understanding of the concerns related to turnover in the Department, and the compensation group in the Human Resources Department was working with Mr. Britt on the organization of the Department. While the University gained when highly trained and experienced members of the Internal Audit staff joined other departments and divisions, the Internal Audit Department did have difficulty delivering its audit plan. To address the turnover problem, the compensation group and Mr. Britt were considering the establishment of a level within the Department that was a level higher than that of senior auditor that would provide an opportunity for advancement for excellent staff members without leaving the department. The Human Resources Department was also carrying out a compensation survey. While the information about the compensation of internal auditors was not readily forthcoming, the early conclusion was that the University's compensation for internal auditors was competitive among public-sector institutions in Toronto but not competitive with the private sector. The Internal Audit Department did act on a regular basis to invite applications, and Mr. Britt was very pleased with the qualifications of the most recent appointee to the Department, who had previously served in the Ontario public service. Mr. Britt concluded that while every effort was being made to ensure that the Department was fully staffed, he could not at this time promise that the full audit plan could be delivered.

3. Internal Audit: Annual Report, 2005-06 (Cont'd)

(c) Use of accounting students. A member asked whether the Internal Audit Department engaged accounting students. Mr. Britt replied that experience in internal audit departments did not at this time count towards meeting the training requirements of the Institute of Chartered Accountants. The Institute was however considering the matter with respect to training for the internal audit specialty requirements. Mr. Britt was a member of the group considering the matter.

4. Internal Audit Plan, 2006-07

Mr. Britt presented the Internal Audit Plan for 2006-07. It included 8500 hours of auditing - a conservative, realistic number of hours, especially in the light of the current vacancy in one senior auditor position. Mr. Britt reviewed the Department's organization chart and stressed that all audit staff had professional designations. He reviewed the plan's objectives, which were consistent with the new Internal Audit Policy. He then reviewed the scope of the plan, which included departmental audits of academic, administrative and student-service units on all three campuses, information systems auditing, continuous auditing of selected transactions in all budget units, assisting Ernst & Young with the external audit, follow-up reviews, special reviews and responses to requests.

Mr. Britt said that departments had been selected for audits based on their risk ranking in the Department's Risk Self-Assessment Database as well as on the basis of requests. The department was about to update its database, and that might have an impact on the divisions selected. If so, Mr. Britt would report changes to the Committee at its next meeting. Mr. Britt then commented on each of the planned audits.

In response to a question, Mr. Britt said that the most significant element of budget risk in the University was the generation of budgeted revenue. While expenses were carefully controlled through the central system, divisions could budget for spending to be covered by revenue from cost-recovery activities and services such as continuing-education courses. When divisions finished the year with a deficit, it was most frequently because of a failure to achieve the projected level of revenue. The audits would review the projections of revenue for the various cost-recovery activities and services to ensure that they were realistic.

5. Internal Auditor: Private Meeting

The Chair recalled that the Committee met at least annually with the internal auditor, with no members of the administration, the Secretariat or the external auditors present. During that meeting, Mr. Britt was asked to state, pursuant to item 6 of the Committee's Terms of Reference, "whether adequate cooperation has been received from management and whether management has exerted any undue pressure." Mr. Britt was also invited to bring to the attention of the Audit Committee any other matters he deemed appropriate.

THE COMMITTEE MOVED *IN CAMERA*.

The Committee met privately with the internal auditor.

THE COMMITTEE CONCLUDED THE *IN CAMERA* SESSION.

The Chair stated that there were no matters arising from this meeting that would require action. On behalf of the Committee, the Chair thanked and congratulated Mr. Britt and the members of his team for their excellent work through the year. She also congratulated Mr. Britt on his nomination for a two-year term as President of the Toronto Chapter of the Institute of Internal Auditors.

6. Borrowing Strategy: Status Report

Ms Brown said that the annual status report on the University's borrowing strategy showed that the strategy was on track. The report included (a) an update on the University's borrowing in comparison to its borrowing capacity and (b) a report on the Long-Term Borrowing Pool, the University's internal sinking fund for accumulating funds for the repayment of the debentures when they became due. The University's maximum external borrowing capacity, which was defined as 40% of the University's average net assets over the past five years, was – taking into account the April 30, 2006 financial results – $621.2-million. The maximum internal borrowing capacity from the Expendable Funds Investment Pool (EFIP) was $200-million, and a review of the EFIP cash flows showed that that level of lending was still affordable. Maximum borrowing capacity was therefore $831.2-million. To date, borrowing of $761.4-million had been approved, including the $200-million capacity from EFIP. That included loans arranged for individual projects prior to the 2001 Borrowing Strategy, the $160-million series "A" debenture, the $200-million series "B" debenture, and $150-million of further borrowing approved on June 17, 2004. To date, $730.5-million of borrowing had been allocated, as approved through the Planning and Budget Committee and the Business Board. Therefore, further borrowing of just over $30-million could be allocated, and further borrowing of just under $60-million could be considered for approval within the maximum borrowing capacity. Actual borrowing outstanding was currently $483.7-million from external sources and about $100-million of internal loans from EFIP.

A member thanked Ms Brown for a very good and informative report. He noted that the target for external borrowing had been one third of net assets, with the maximum having been set at 40%. It appeared that the maximum was now being accepted as the norm. Ms Brown replied that if the University's net assets were to decline to the point where the amount of borrowing were to exceed the permissible maximum of 40% of net assets, then there would be no further borrowing until net assets had grown such that borrowing was 33% of net assets. She noted that net assets had reached their lowest point in 2003, and that the 2003 net assets were still included in the five-year rolling average.

7. Report of the Administration

Ms Riggall, Ms Brown, Mr. Piché Mr. Charpentier and Mr. Britt stated that they knew of no other matters that should be drawn to the attention of the Audit Committee at this time.

8. Date of Next Meeting

The Chair noted that the Committee's schedule for 2006-07 had not yet been established. It would be distributed over the summer.

9. Other Business

(a) Ms Sheila Brown

Ms Riggall reported with pleasure that Ms Brown had been elected as President of the Canadian Association of University Business Officers (CAUBO) for 2006-07. Mr. Britt served as Ontario representative on the Internal Auditors Standing Committee of CAUBO.

(b) Chair's Year-End Remarks

On behalf of Mr. Myhal, the Chair thanked all members for their service over the year. She offered special thanks to members who were completing their terms.

- **Mr. David Oxtoby** had served on the Committee over the past four years, and would be concentrating his efforts in 2006-07 as a member of the Business Board.

- **Mr. Roger Parkinson** had served on the Business Board for nine years and on the Audit Committee for eight years. He would serve as a member of the Academic Board of the Governing Council in 2006-07.

- **Mr. Chris Sparks**, because of the new terms of reference, would be the last member of the administrative staff to serve as a voting member of the Audit Committee. He had served over the past two years.

- **Mr. Mark Weisdorf** had served for the past two years. His service in this past year has been particularly commendable, in that he had commuted or telephoned from New York to complete his commitment to the work of the Committee.

The meeting adjourned at 7:30 p.m.

Secretary Vice-Chair

September 19, 2006

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