REVISED

UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 70 OF THE AUDIT COMMITTEE

October 29, 2003

To the Business Board,
University of Toronto.

Your Committee reports that it met on Wednesday, October 29, 2003 at 4:00 p.m. in the Board Room, Simcoe Hall, with the following members present:

Mr. George E. Myhal (In the Chair)
Ms Paulette L. Kennedy
Mr. Paul E. Lindblad
Mr. Gerald A. Lokash
Mr. David Oxtoby
Professor Gordon Richardson
Mr. Robert S. Weiss

Mr. Felix Chee, Vice-President, Business Affairs

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

Secretariat:

Mr. Neil Dobbs
Ms Cristina Oke

Regrets:

Ms Kim McLean
Mr. Richard Nunn
Mr. Roger P. Parkinson

In Attendance:

Mr. Curt Auwaerter, Vice-President - Finance, University of Toronto Press*
Ms Kathryn Bennett, Senior Vice-President - Administration and Human Resources, University of Toronto Press*
Mr. Keith B. Bowman, Ernst & Young
Mr. George Meadows, President and Publisher, University of Toronto Press*
Mr. Allan H. Shapira, Hewitt Associates**

* In attendance for item 4.
** In attendance for item 3.

1. Report of the Previous Meeting

Report Number 69 (June 18, 2003) was approved.

2. Business Arising from the Report of the Previous Meeting

The Chair referred to the “follow-up list” of items arising from previous meetings of the Committee. He noted that most items would be dealt with through the year in the usual course of business. He said that he would work with the Secretary to cull those items in order to begin the year with a fresh slate of items for follow-up.

REPORT NUMBER 70 OF THE AUDIT COMMITTEE - October 29, 2003

THE FOLLOWING ITEMS ARE RECOMMENDED TO THE BUSINESS BOARD FOR ACCEPTANCE.

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003

Ms Brown said that the annual report covered the University's three pension plans: (a) the defined-benefit plan for most University employees, (b) the defined-benefit plan for employees of the Ontario Institute for Studies in Education (OISE) who had begun their employment before its merger with the University's Faculty of Education, and (c) the non-registered Supplemental Retirement Arrangement. The report was for the pension-plan year ended June 30, 2003 with the actuarial reports being prepared as of July 1, 2003. The University plan had accrued liabilities of $2,066.7-million. The market value of the plan's assets was $1,863.2-million, leaving a market-value deficit of $203.5-million. The much smaller OISE/UT plan enjoyed a market value surplus of $7.1-million. The accrued liability of the Supplemental Retirement Arrangement was $108.6-million, with the funds set aside in committed capital valued at $91.2-million as of June 30, 2003, leaving a shortfall of $17.4-million. The outcome was a total market-value shortfall in the funding of the retirement plans amounting to $213.8-million.

Ms Brown recalled that the Committee had at its June meeting reviewed the University's audited financial statements for the year ended April 30, 2003, which included information on the pension benefit plans showing a deficit position of $398.3-million. There were two reasons for the smaller amount of the market-value deficit of the three University pension plans that was reflected in the current report. First, the University's April 30 financial statements included the liabilities of the two registered plans and the Supplemental Retirement Arrangement, but the assets only of the registered plans. That was the case because the monies set aside as committed capital in the University's accounts for the S.R.A. could not, according to the Income Tax Act, be regarded as assets in trust for pension benefits. Rather, those assets were legally available to satisfy the University's creditors, could be applied to any other purpose the University might determine from time to time, were legally commingled with the University's other assets, and were not subject to the direct claim of members of the arrangement. Second, the July 1 report also reflected the improvement in the securities markets in the months of May and June, 2003, with a $55-million growth in the value of the assets in the two registered pension funds.

Among the matters that arose in discussion were the following.

(a) Investment management of the pension fund assets: responsibility for asset mix. The Chair recalled discussion in the Business Board about clear assignment of responsibility for pension-fund asset mix to the University of Toronto Asset Management Corporation (UTAM), within the parameters of the University's Pension Fund Master Trust Investment Policy (Statement of Investment Policy and Goals). UTAM's actions would be guided by the University's return requirement (an average of 4% per year plus the increase in the Consumer Price Index, averaged over a ten-year period) and the University's risk tolerance (a maximum standard deviation of 10% or less in nominal terms over ten-year periods). Ms Brown replied that that was clearly the intention, and both the service agreement and the University Funds

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

Investment Policy had been amended to reflect that intention. The Pension Fund Master Trust Investment Policy, as amended in April 2003, however, followed the same pattern as earlier policies. There had been some difficulty in amending the pension fund policy because of the need to combine (i) the University's intention to delegate asset-mix authority to UTAM, with (ii) the prescribed contents for statements of investment policies and goals, as required under the Ontario Pension Benefits Act. The work on appropriate asset-mix guidelines had been completed and a new policy reflecting the new intention would be put before the Business Board for approval in January 2004.

Mr. Chee added that the return objective of the pension fund had always been clearly understood to be at least a nominal return of 7%, which was the discount rate applied to the pension plans' liabilities. That objective was not that far from the objective that had been established for the endowment funds, which was 4% plus C.P.I. There had, therefore, been no need for extensive asset-mix modeling to determine the appropriate asset mix for the pension fund. Some adaptation was required, however, because of the legal limit on foreign investments in Canadian registered pension plans. Given the similarity of the objectives and the risk tolerance, it would be possible to manage both portfolios as one larger one, although each would remain separate. The new asset mixes for both the endowment and pension funds had been approved by the UTAM Board and were being implemented.

(b) Pension plan strategy. In response to a question, Mr. Chee said that the report currently before the Committee was the annual stewardship report, which included the pension funds' audited financial statements and plans' actuarial valuations. The strategy for ensuring the funding of the pension plans was being addressed as a separate issue going forward. There were obvious gaps that would require attention.

(c) Investment management: Hedging and derivatives. In response to a member's questions, Mr. Chee said that derivatives were used in two ways. First, UTAM used an external currency-overlay manager for hedging foreign-currency exposure. The manager's benchmark was a 50% hedged position, but the manager was permitted to hedge a greater or lesser portion of the investments denominated in foreign currencies back to the Canadian dollar. That manager used forward contracts to execute the hedging program. Derivatives were used, second, for synthetic foreign index-fund investments. UTAM or its external managers purchased futures contracts on various national securities-market indices rather than investing directly in the stocks in those indices. The underlying amounts were fully backed with cash invested in short-term fixed-income securities. UTAM used this sort of investment when making changes in its external managers. UTAM did not use derivatives or other methods to hedge stock exposure. In the regular portfolios, managers were measured by their performance against benchmark securities indices, for example the Russell 3000 Index of U.S. stocks. Therefore, the managers sought to add value by over-weighting sectors and selecting securities that would outperform their indices. The hedge fund managers, who were responsible for only a relatively small proportion of the funds, did hedge against declines in the market by selling stocks short that they expected to decline in value. Mr. Chee noted that some of the monies invested by external managers were placed in pooled funds. In such cases, the derivatives in the pooled funds would not be captured in the financial-statement note 4(d) on derivative financial instruments.

(d) Investment management: benchmarks for evaluation of performance. A member observed that investment performance had been reported before fees; he was used to seeing

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

performance reported net of fees. Mr. Chee replied that, while in a retail setting, performance was reported net of fees, for institutions, performance was typically reported gross of fees. To compare UTAM to other institutional managers, it was necessary to report performance in the same way. Mr. Chee observed that there was one exception to this practice: hedge funds reported their performance net of fees. Mr. Chee said that UTAM had submitted data going back five years to a service used in Canada and the U.S. in order to obtain a picture of the value added by UTAM relative to the fees paid by the University.

Mr. Chee noted that UTAM had adopted, as one of its performance benchmarks, performance relative to a peer universe. While comparative performance had for most of the past three years been poor, performance in the most recent quarter for which figures were available (that is the second quarter of 2003) was in the top quartile. Indeed, one of the funds had ranked in the top decile. He anticipated that performance for the third quarter would also be better than that of the median fund, although possibly not in the top quartile. When the stock markets in general had been losing ground, UTAM's relatively heavy weighting in stocks had been costly. With the recovery in the equity markets beginning in March 2003, that relatively heavy weighting in equities had boosted the performance of UTAM's funds.

A member observed that there appeared to be some confusion in the report concerning the benchmark for performance measurement. On page 9, the report commented on the pension fund's annualized return relative to all criteria for the four-year period ended June 30, 2003: "The pension Master Trust exceeded the market index benchmark by 1.9%, but fell short of meeting both the CPI plus 4% objective and the Median balanced fund objective by 4.2% and 1.7% respectively." On page 13, however, the "Highlights" contained in the financial statements referred only to performance relative to the composite benchmark, and reached the conclusion that "the pension Master Trust has withstood the downturn well." The member also urged that there be greater stress in the report on longer term returns over periods such as four years. The member took little comfort in improvements in ranking relative to peers for only a short period.

Mr. Chee agreed. He noted that UTAM had only in the past year adopted as one of its benchmarks comparisons to a peer universe. It had previously measured itself only against a benchmark of a composite of securities indices, reflecting the normal asset mix contained in the investment policies, and it had focused its efforts on exceeding the performance of the various indices and hence of the composite-index benchmark.

Another member urged that for the sake of new readers of the report, the comments on investment return refer consistently to both benchmarks and that the report include a discussion of the remedial action being taken to improve returns. Given expressions of concern in the past, the report should give the clear impression that there was no effort to hide any aspect concerning investment returns and that action was being taken to address the questions that had been raised.

Mr. Chee understood the force of the member's comment. The report now before the Committee was, however, an annual financial report on the pension plans. Explanations of investment actions would be better contained in a separate document. Mr. Chee anticipated considerable debate within the University community, and indeed within the broader community, on appropriate investment objectives. For example a return of 6% per year might in some circumstances exceed both a reasonable composite benchmark and the performance of the median fund of a comparative measurement service, but it might still leave pension plans in a deficit position. The key objective should, in Mr. Chee's view, be obtaining the return necessary to meet the pension plans' liabilities and doing so with acceptable risk.

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

(e) Currency. A member observed the statement on page 9 of the report, commenting on the returns of the Pension Fund Master Trust: "While markets have rebounded since March 2003, the appreciation of the Canadian dollar also added volatility to the pension return." On page 21, however, note 3b) to the financial statements of the University plan showed a foreign exchange gain of $55-million. Mr. Chee replied that foreign currency exposure was hedged at a benchmark 50%, with the currency overlay manager having the responsibility of hedging more or less than 50% of the exposure. The note showed that, because of the decline of the U.S. dollar and many other foreign currencies against the Canadian dollar, hedging activities had produced positive returns. But, because the fund was only partly hedged during the year, the fund had not been protected from the full impact of the Canadian dollar's appreciation. In the past year, for example, the Standard and Poor's 500 Index of large U.S. stocks had gained about 17% in U.S. dollar terms, but only 2% in terms of the Canadian dollar, because of the loss in the value of the U.S. dollar relative to the Canadian dollar. Because the pension fund was partly hedged, it had enjoyed a return greater than 2% but less that the 17% enjoyed by U.S. investors. Mr. Chee noted that the University's endowment participated in the Cambridge Associates survey of North American endowment fund returns. Because of the benefit of the gain in the Canadian dollar, which was the currency of all of the endowment's fixed income investments as well as a small portion of its equity investments, the University of Toronto's endowment was reported as a top performer in the survey in the past year, with the survey measured in terms of U.S. dollar returns. Mr. Chee also noted that in order to measure the returns provided by the various external portfolio managers, UTAM compared their performance in terms of the base currencies in which they invested. The performance of the full funds were measured in Canadian dollars. It therefore became necessary to attribute the fund's performance to two factors: investment returns and currency hedging.

(f) Investment of the pension fund: alternative assets. A member observed that U.S. funds were moving more in the direction of investing in alternative assets including private equity and hedge funds. Would UTAM be comfortable moving in that direction? Mr. Chee replied that the current asset mix was comparable to the traditional mix of 60% equities and 40% fixed income. However, included in the 60% weight in equities was 10% intended for private equity investment. Of the 40% for other investments, 30% would be invested in bonds (including real-return bonds) and 10% in absolute-return hedge funds. It was anticipated that the absolute-return hedge funds would provide a return comparable to usual fixed-income securities with a similar volatility, but their use would provide a hedge against the losses that would be incurred by fixed-income portfolios if interest rates rose.

Mr. Chee stressed that hedge funds did not represent an asset class but a rather a wide range of strategies. Some hedge funds, the absolute-return funds, were expected to produce returns comparable to bonds, and they were the funds included in this particular element of the new asset mix. Mr. Chee cautioned that the use of alternative asset classes was new for the pension fund, although they had been used to some extent in the endowment fund. Therefore, some time would be required to ramp up those investments to the levels indicated in the new asset mix as approved by the UTAM Board.

(g) Leadership at UTAM. In response to the Chair's question, Mr. Chee reported that since the departure of Mr. Donald Lindsey, the founding C.E.O. of UTAM, Mr. Chee had been seconded to look after the operation, and he was spending three days per week at UTAM and the remaining two days at the University. The Board had been reconstituted and reduced in size. All of the directors had substantial expertise in investment matters, and the Board was operating very much

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

like an investment committee. The Board was now chaired by Mr. Ira Gluskin, President of Gluskin Sheff. Mr. Chee had spoken with the President about the resolution of the executive leadership situation, and Mr. Chee anticipated that a decision would be made in a month or less. The Chair asked that Mr. Chee report the outcome to the Committee at its next meeting.

A member noted that he took comfort in the fact that the matter would be resolved in the near future. He asked whether key priorities were being taken care of. Mr. Chee replied that what needed to be taken care of was being taken care of with due diligence. The need, however, was for time to undertake other initiatives.

(h) Pension fund liabilities. In response to the Chair's questions, Mr. Chee said that the liabilities of the pension plan had been discounted at a rate of 7% per year to obtain their present value. Mr. Shapira said that some modest enhancements to benefits had been implemented effective July 1, 2002. More significantly, an increase in the maximum pension limit under the Income Tax Act had increased the accrued liability of the University plan by $43.4-million as of July 1, 2003, but it had also reduced the liability of the Supplemental Retirement Arrangement by the same amount. Other than those factors, there had been no plan improvements.

(i) Funding of the Supplemental Retirement Arrangement. The Chair observed that on one hand the University was setting aside committed capital in a special "fund for a specific purpose" to match its liability under the Supplemental Retirement Arrangement. On the other hand it was borrowing money to complete capital projects. Did the administration anticipate that it would earn more on this special fund than its cost of the capital borrowed for capital projects? In response to the Chair's questions, Mr. Chee and Ms Brown said that the University had wisely decided to be conservative, to regard the liability under the Supplemental Retirement Arrangement as a pension liability, and to accumulate and manage the fund for specific purposes against the liability. Mr. Chee observed that the University should be able to achieve a 7% return in the long run, matching the cost of the University's borrowing. It would be important to manage the fund conservatively and to ensure that volatility did not exceed one standard deviation. The credit rating agencies had, in establishing the University's credit rating, taken into account the fact that the University had prudently set aside assets to match the S.R.A. liability. In the absence of that prudence, the University's cost of capital would likely have been higher.

(j) Audited financial statements, financial-statement assumptions and actuarial assumptions. In response to a member's questions, Mr. Bowman said that the external auditors were satisfied with the financial statements and ready to sign off on them. He had consulted with Ernst & Young's specialist partner in pension-plan accounting and he was comfortable with the management estimates used in the preparation of the statements.

Mr. Shapira said that he was comfortable with the assumptions. He noted that the actuarial assumptions were based on long-term experience, whereas those in the financial statements were based on more immediate, market rates. For example, in the actuarial valuation, the accrued liability had been discounted by 7% to determine their present value. In the financial statements, the actuarial present value of the plan's accrued pension benefits was based a discount rate equal to the interest rate for AA bonds, which had been 6.79%. That had since declined by between 70 and 85 basis points. If that continued, it would be necessary to consider a lower discount rate for next year's financial statements. Another assumption was the inflation assumption, which was currently 3% per year for the actuarial valuation. While that might depart from experience from year to year, the important factor in the valuation was the spread between the inflation

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

assumption and, one hand, the interest rate assumption and, on the other, the assumption concerning the rate of compensation increases. The inflation assumption was common to the valuation of both the liabilities and the assets.

A member noted that in the reconciliation of the surpluses between July 1, 2002 and July 1, 2003, all of the adjustments compared to assumptions had resulted in losses rather than gains. Mr. Shapira replied that this had been an unusual situation for the past year. If this were unexpectedly to persist over time, it would be appropriate to change the assumptions.

A member noted that in some corporate pension plans, the surplus had deteriorated and the corporation had still booked pension income. This appeared to be little less than "witchcraft." Were rule changes likely? Mr. Shapira replied that this had been the outcome of amortizing both gains and losses in pension surpluses (deficits) over a number of years. The international body that set accounting rules was considering a shift to the more immediate recognition of losses, and that change, if it was to take place, might affect Canadian accounting principles. Mr. Shapira noted that under the present rules, unless a pension plan was to enjoy better years, current losses would eventually have to be recognized in corporate results.

(k) Current-service contribution. A member observed that the current service cost for the University' main registered plan was $67.3-million, with required participant contributions amounting to $24.4-million, leaving a remaining current service cost of $42.9-million. Even though the plan was barely in an actuarial surplus position and in a significant market deficit, the report (on page 11) said that "the University anticipates making contributions to the RPP of approximately $18.8-million in 2003-04." Mr. Shapira replied that this would be factored into the deficit next year. This report would not be filed with the regulators to allow flexibility in the timing of the University's contributions. Ms Brown said that she anticipated that a total of $27-million would be paid into the pension plan before June 30, 2004.

The member asked that this matter be noted for follow-up by the Committee. Ms Brown said that the matter would be included in the forthcoming pension plan funding strategy.

(l) Solvency valuation. A member observed that there were two solvency valuations. In one case, when the solvency liability was calculated without "escalated adjustments (future indexing)," the market value of the assets as at July 1, 2003 exceeded the solvency liability. If the cost of indexing benefits was included, however, the market value of the assets would fall short of the solvency liability by $343-million. Mr. Shapira replied that the solvency valuation was intended to show what would happen if the University were to become insolvent and the pension plan had to be wound up, with annuities being purchased to meet existing pension entitlements. In such a case, there would be no further salary increases to deal with, but there was the issue of providing benefits that were 75% indexed to inflation. It would, in fact, be very difficult to purchase inflation-indexed annuities; therefore the solvency valuation could ignore the cost of indexing. If there was a solvency deficit, the regulators required that the employer make contributions to make good the solvency deficit over five years. It would make no sense to fund the plan on a wind-up basis for something that would not happen – the University's insolvency. Therefore the valuation showed both numbers, with the University operating on the basis, allowed by the Ontario Pension Benefits Act, of the solvency liability without future indexing.

3. Pension Plans: Annual Stewardship Report for the Year ended June 30, 2003 (Cont'd)

On the recommendation of the Vice-President, Business Affairs,

YOUR COMMITTEE RECOMMENDS

THAT the audited financial statements for the University of Toronto Pension Plan, June 30, 2003, a copy of which is included in Appendix "B" hereto, be approved; and

THAT the audited financial statements for the University of Toronto (OISE) Pension Plan, June 30, 2003, a copy of which is included in Appendix "B" hereto, be approved.

4. University of Toronto Press: Annual Report and Financial Statements for the Year Ended April 30, 2003

The Chair stated that the Press was a separate corporation with its own Audit Committee and its own Board, which was responsible for overseeing its operations and approving its financial statements. The Audit Committee carried the responsibility for the Governing Council's - the controlling corporation's - stewardship with respect to the U of T Press. The Press's annual report and financial statements would be on the Business Board agenda, but as a "consent" item. Given the Audit Committee's review, there would be no presentation of the item at the Business Board, and there would normally be no discussion, unless a member were to give notice of concerns. Because the annual report and financial statements had been approved by the Press's own Board, the Audit Committee was asked to recommend that the Business Board "accept" rather than "approve" those documents.

Mr. Meadows briefed the Committee on developments since the April 30, 2003 end of the fiscal year. The Press's operations and earnings had been severely disrupted by a number of unusual factors: the SARS outbreak (which had caused the cancellation of a number of scholarly conventions and other events for which the Press would have provided printing); the August power blackout; the Ontario election (which meant that the legislature was not in session and the Press did not print a Hansard record), and even the Rolling Stones concert (which had impeded traffic flow around the Press's Downsview warehouse and printing plant). Mr. Meadows projected a loss of about $300,000 arising from those events, which the Press would try to turn around in the remainder of the year. There were some encouraging signs. The printing operation was beginning to pick up (aside from Hansard printing, with the Legislature not yet back in session). The publisher Douglas and MacIntyre had resumed using the Press's distribution service.

Mr. Meadows replied to several detailed questions. Among the more general matters that arose in discussion were the following.

(a) Distribution. In response to questions, Mr. Meadows said that the distribution operation had run into a number of specific problems as well as more general ones. At the time the Press was enlarging its warehouse by building a mezzanine, a major publisher had become bankrupt, leading to a large inflow of books to the warehouse. Salary costs had increased dramatically as overtime work was required, putting the salary costs about $1-million over those of the previous year. Very

4. University of Toronto Press: Annual Report and Financial Statements for the Year Ended April 30, 2003 (Cont'd)

high rates of book returns by some new client publishers raised the expenses of the distribution operation. In addition, a very high rate of book returns by a large bookstore chain raised expenses.
Efforts to encourage publishers to ship fewer books, rather than incur such a high level of returns, had not met with success. The Press had been forced to tell client publishers that it would not be able to continue to provide distribution and warehousing services for a charge of 4% of sales.

Mr. Chee observed that the distribution business was more than a warehousing and logistics business. It was, in effect, also a factoring business. It was a quirk of the publishing industry that publishers booked sales even when they knew that a large proportion of those sales would be returned. In those circumstances, the distributor became a factor, lending the publisher money on the basis of sales and awaiting a return of part of the money when the unsold books were returned. It was ironic that such *de facto* lending was provided to clients who could not secure bank loans. The Board of the Press had therefore reached the conclusion that the Press should leave the factoring business, instead offering to provide distribution services strictly on a fee-for-service basis.

(b) Viability of the business model. A member asked whether Mr. Meadows thought that the Press would be able to continue to carry out its mission - printing scholarly books on the basis of earnings in its other divisions - within the basis of the current arrangements with the University. Mr. Meadows replied that there was a limit on the capital the University would supply to the Press. Mr. Meadows thought that the Press would be able to continue to achieve its mission within that limit. The problems in the distribution operation could be solved, likely by providing a full roster of services to client publishers: printing, warehousing and shipping their books. A key would be the recovery of the printing business, which was showing promising signs of improvement. The Press was winning better and larger printing contracts. Its QuickPrint operation on College Street had been able to obtain better prices for its services.

Mr. Chee said that it would be possible to see other models for scholarly publishing. The University might seek to sell the Press and then use the proceeds for an endowment to subsidize scholarly publications. The Press had, however, made its model work. The planned changes to the distribution business would help the Press financially. Mr. Chee said that the Press regularly reviewed its various businesses. Given the sunk costs, it had been concluded that it would make sense to remain in the printing business. It had also been concluded, although not unanimously, that the retail business should be retained. The Press's businesses were tough ones to operate profitably, making it difficult of the Press to support scholarly publishing at the University, but Mr. Meadows and his colleagues had succeeded remarkably well.

On the recommendation of the Vice-President, Business Affairs,

YOUR COMMITTEE RECOMMENDS

THAT the annual report and audited financial statements of the University of Toronto Press for the year ended April 30th, 2003, a copy of which is attached hereto as Appendix "A", be accepted.

4. University of Toronto Press: Annual Report and Financial Statements for the Year Ended April 30, 2003 (Cont'd)

The Chair and Mr. Weiss advised the Committee that Mr. Meadows would reach retirement age this year. This would, therefore, be his final report to the Audit Committee. Mr. Meadow's achievements at the Press had been extraordinary. The Press's mission was to carry out a world-renowned scholarly publishing program, funded by profits from its commercial operations. Under the leadership of George Meadows, the Press had consistently achieved this mission, and it had done so with exceptional success. The operation had been profitable for ten out of the eleven years it had operated as an ancillary corporation. It had been able in many years to contribute to the University's scholarly publishing endowment and to pay participating interest to the University for the first three million dollars of the capital invested in the Press by the University. Most significantly, the Press had in recent years been able to publish over 200 academic titles a year. And, it had in recent years also been able to say that it had not been forced to turn down a book for publication that had been deemed worthy of publication by its review committee.

THE FOLLOWING ITEMS ARE REPORTED FOR INFORMATION.

5. Chair's Remarks

The Chair welcomed the Committee's new member, Mr. Oxtoby, and continuing members and others present introduced themselves. That so many members had experience on the Committee would be very helpful. It would provide the flexibility to tighten the Committee's process for considering items and would reduce the time needed for meetings. While not wishing to stifle discussion, the Chair would make every effort to limit meetings to two hours. If, when it came time to move on to a new item on the agenda, members had remaining questions, they would be invited to ask them at the end of the meeting if time remained or to ask the questions off-line.

The Chair reminded members that the Committee normally met in closed session. That meant that meetings were open only to members, as well as any members of the Business Board or Governing Council who might wish to attend. In addition, appropriate members of the University staff would attend. This differed from most other Governing Council committees, which normally met in open session, allowing members of the public to attend. The Audit Committee received a great deal of written material of a highly confidential nature. Some items would become very public after the Committee had dealt with them, such as the University's financial statements. Other material, however, such as the Internal Auditor's plan, had to remain private. Proceedings taking place in closed session were not to be discussed outside of the Committee, except with people who would be entitled to attend the meeting - other Committee members, Business Board members or Governing Council members. Appropriate documentation and the record of the Committee's proceedings would be released by the Secretariat in accordance with usual practice or the Chair's instructions. From time to time, the Committee would move *in camera* to discuss particularly sensitive matters off the record. In those cases, only members and specified staff would attend, and the information should not be disclosed to others. Members were therefore asked to treat the information they received as members, and the Committee's discussions, with a high level of discretion. In this connection, members of the Committee, like those of the Governing Council and Business Board, would be asked to sign an "Acknowledgement and Undertaking of Confidentiality" agreement.

6. Orientation Information

The Chair reported that Ms Brown had kindly updated the slides used at the previous year's orientation. Because there was so much continuity of the Committee's membership and because Ms Brown and Mr. Oxtoby had spent time before the meeting going over the information, it had been decided to distribute this information but not to ask Ms Brown and her colleagues to present it. Members with any questions were invited to be in touch with the Chair or Ms Brown after the meeting.

7. University Credit Rating

It was proposed by the Chair and agreed that the Committee add to its agenda receipt and consideration of an oral report on the recent changes to the University's credit rating. Ms Brown reported that two of the three credit-rating agencies that maintained a rating for the University had completed reviews of that rating, and the third agency was expected to do so in the near future. Standard and Poor's had reduced the University rating from AA+ to AA, the same credit rating as the Province of Ontario. Moody's had re-affirmed the University's AA high rating, again the same credit rating as the Province, but had indicated a negative outlook. The change had arisen from the stated intention of the new governing party in Ontario to freeze tuition fees and uncertainty about whether the reduced revenue would be made up by increased operating grants. The difference in the ratings arose from differences in the approach of the two agencies. Standard and Poor's ratings were based more upon near-term consequences of changes. Moody's ratings gave more emphasis to long-term prospects and paid more attention to management responses to new circumstances. In the case of the University of Toronto, some financial weakness had arisen from poor investment returns. The agency, however, understood that markets were volatile, recognized the recovery in the equity markets since the University's April 30 fiscal year end, and took into account management action, in particular the decision to reduce the endowment payout rate in response to the period of poor investment returns. The Chair observed that the University's credit ratings were still outstanding.

Two members asked about the impact of the changed ratings. Mr. Chee and Ms Brown replied that investment dealers anticipated no impact with respect to the planned new debenture issue. High-quality, long-term debentures, and in particular university issues, were in short supply, and little new issuance was expected, apart from the University of Toronto's issue. The likely impact would be on the amount the University could borrow without impairing its credit rating. Mr. Chee had estimated that the University could borrow up to one third of the value of its capital. That threshold was now a firmer one. Standard and Poor's, which focused more on shorter term matters, had no doubt observed that the University's capital had been declining over the past three years, and was likely signaling that, in order to restore the University's flexibility to borrow further, it would be necessary to restore its capital structure. In response to the Chair's question, Mr. Chee and Ms Brown said that the rating agencies were well aware of the University's intention to issue a further $200-million of debt; that intention had in fact been made clear at the time of the first debenture issue. Debt beyond that level, in particular beyond one third of the University's capital would, however, likely have unfavourable consequences with respect to the University's credit rating.

The Chair instructed the Secretary to distribute the press releases concerning the new ratings.

8. Audit Committee: Review of Role and Responsibility

The Chair recalled that, at its June meeting, the Committee had begun a self-examination, especially in the light of changes in expectations of audit committees. It had been agreed at the time to defer the discussion until this meeting, when there might be more clarity with respect to expectations of audit committees in Canada and especially those of not-for-profit organizations.

Invited to comment, Mr. Bowman said that the University's Audit Committee was meeting all current requirements. A number of possible changes were, however, under discussion. Audit Committees might be called upon to give prior approval to any non-audit services to be performed by the external auditors' firm. There might be a requirement for a formal process for staff members to report concerns of financial impropriety. The University of Toronto already had such a process in place. There might be a requirement for more independent and financially literate directors to sit on audit committees. At the University of Toronto, all voting members of the Committee were independent of the administration and there was a high level of financial literacy.

Among the matters that arose in discussion were the following.

(a) Management sign-off on the financial statements and on the adequacy of internal financial controls. A member asked whether the Vice-President, Business Affairs was comfortable in signing off on the annual audited financial statements. This was an important question given higher expectations and given the extraordinary decentralization of financial management in the University. Was the Vice-President confident about the reliability of the information going into the financial statements, its cumulation, the judgement calls involved in presenting this information and the appropriate application of accounting principles? Mr. Bowman concurred that personal responsibility of chief executive officers and chief financial officers with respect to financial statements was being taken to a new high level. Another member asked whether the Vice-President would be comfortable signing off that adequate internal financial controls were in place.

Ms Brown noted that the President and the Vice-President, Business Affairs did sign a statement of administrative responsibility, which was included in the financial statements package. They also signed a letter of representation to the external auditors.

Mr. Chee replied that the institution as a whole could provide such sign-off on the financial statements and on overall financial controls, but that real accountability would require sign-off by the President and the Vice-President and Provost. The academic divisions were under the administrative supervision of the Provost, and the business officers did not report, either directly or secondarily on a dotted-line basis, to the Vice-President, Business Affairs as chief financial officer.

A member observed that it would be important for the Committee to consider this situation. Could the Committee be satisfied that it was discharging its responsibilities with respect to controls and regulatory requirements when its senior assessors could not speak with authority on financial matters in the academic divisions? Mr. Chee replied that it would be appropriate to address the question to the President.

In response to the Chair's question, Mr. Bowman said that there was currently no requirement for the chief executive officers to sign off on internal controls, but a member noted that a sign-off requirement was included in the draft requirements issued by the Canadian Securities Administrators.

8. Audit Committee: Review of Role and Responsibility (Cont'd)

The Chair observed that there appeared to be no problem concerning internal controls. The question instead was about the division of labour within the senior administration and about which officers would be in the best position to sign off.

Mr. Chee and Ms Brown stressed that there were strong controls built into the decentralized financial system. For example, while principal investigators (the faculty members leading research operations funded by grants or contracts) could requisition salary payments from restricted funds such as their research grant or research contract accounts, their Department would be charged for any shortfall. Budgetary shortfalls in academic divisions or departments were usually the outcome not of overspending expense budgets but rather failing to generate the projected divisional revenues. While it would be difficult to spend money that was not in an approved divisional / departmental budget, one problem that might have to be watched was inappropriate budgeting, including excessive amounts in particular accounts that could then be misused. This was, however, an unlikely problem given the extreme tightness of monies in the University and in each of its budget units.

(b) Periodic financial reporting. The Chair expressed his concern about the absence of timely, interim financial statements. It was important to have information in order to act to deal with problems. Mr. Chee replied that the heads of the budget units and their business officers were well aware of financial developments in their division / department. Given the tightness of resources, they had to be up to date. The problem was the absence of a good infrastructure to produce institution-wide reports. It would be ideal and would provide good discipline to produce quarterly statements. By the time the current financial forecasts became available, it was often too late to take action to deal with any problem that might emerge. Ms Brown noted that the administration assembled financial forecasts after six and nine months of the fiscal year, providing reports as at October 31 and January 31. In addition, she assembled monthly variance reports beginning in October of each year on certain large accounts such as the government funding account. With respect to the full financial forecasts, they relied on reports from each division, projecting the division's variances. It had been her experience that efforts to provide more frequent forecasts resulted in less satisfactory information coming forward from the divisions. While divisional officers would find time to submit two reports per year, they would find it difficult to provide more frequent reports.

The Chair concluded that it would be appropriate to look into the possibility of modifying the current system of interim financial reporting, and he asked the external auditors and the internal auditor to look into the matter and to make a recommendation.

A member suggested that even if the administration found it difficult to assemble full quarterly financial reports, it might still be possible to report in a timely manner on certain key indicators. Ms Brown indicated that the central administration certainly did monitor key matters regularly, for example enrolment which was the driver of government grants and tuition-fee revenue.

A member asked whether the absence of more regular interim financial reports was caused by delays in record-keeping. Ms Brown replied that the University had on-line, real-time records. The problem was the time required for the aggregation of information, the comparison of the information to previous periods, and the projection of outcomes.

8. Audit Committee: Review of Role and Responsibility (Cont'd)

Mr. Chee agreed that there was need for a simple, effective monitoring process. For example, there was a very substantial process for monitoring ancillary operations, but it took place only once a year. At this time, however, it had become clear that the University had over 100 vacant rooms at the Chestnut Street Residence and elsewhere, with a further 380 rooms about to come on-stream at the Woodsworth College residence. It was clear that there was a need for action far in advance of the annual review process, in this case proactive work to offer places to categories of students such as graduate students who would not normally be eligible for places in undergraduate residences. Again, the individual operations did review their finances regularly, but there was need for overall quarterly reports including all divisions, comparable to those produced in businesses.

A member observed that a number of questions should be answered. Were periodic financial reports possible? How could they be produced? How useful would they be? What would be the role of the Audit Committee in monitoring such reports?

Ms Brown said that a key problem was resources. Various additional financial reports had been requested. For example, Ms Brown and her colleagues were now producing quarterly reports on spending on capital projects as compared to approved cost. All of this had to be accommodated with no additional staff resources.

The Chair recognized the resource limitations. He did, however, think it appropriate for the external and internal auditor to consider the matter and make a recommendation. If it was practicable and advisable to proceed, the Committee could support the addition of necessary resources.

A member recalled that during the discussions leading to the Committee's current terms of reference, consideration had been given to a Committee role for monitoring regular financial reports and it had been concluded that to do so the Committee would have to be aware of the University's budgeting. More recently, some Committee members had been concerned that the Vice-President, Business Affairs and Chief Financial Officer was involved in only a peripheral manner in budgeting. The member urged that the Committee consider this matter further and make a recommendation for an appropriate outcome, even if that recommendation was not in the end accepted.

(c) Independence of Audit Committee members. A member anticipated that the Canadian Securities Administrators (a body acting on behalf of the various provincial securities commissions) would be bringing down new regulations for public companies in the fall of 2004 and he urged that this be monitored carefully. One concern was the nature of a possible requirement for the independence of members of audit committees. The University's committee included two employees in its voting membership, members of the teaching staff and administrative staff with financial or accounting expertise. Having those members had been very helpful to the Committee, but it might run afoul of rules set with public, for-profit companies in mind.

(d) Audit committee self-assessment. The Chair drew members' attention to an Ernst & Young document that had been included in the agenda package, entitled "Corporate Reform: Implications for Audit Committees." That document included, as its Appendix "A", an audit committee self-assessment questionnaire. Such self-assessment tools were frequently used by private-sector audit committees, and this tool could be adapted for use by the University. This particular document was especially user-friendly, and the Chair proposed to work with Mr. Bowman to adapt it to the University's use. Members would be asked to complete the

8. Audit Committee: Review of Role and Responsibility (Cont'd)

questionnaire, and the results could be used to identify areas where members saw the Committee's performance as deficient. Decisions could then be made to make changes or to accept the deficiencies on the basis that the cost of change would be too great for the benefit. It would at the very least be beneficial to be able to say that the self-assessment had been done and the outcome given careful consideration. In making decisions, the Committee would no doubt wish to hear from Mr. Bowman on steps being taken by other universities to adapt to the new standards.

9. Audit Committee Calendar of Business, 2003-04

The Committee received, for information, its Calendar of Business for 2003-04.

The Chair reported that he had proposed one new matter of business for the Committee. The University was carrying out an exceptionally large program of building expansion. Its construction program was in fact one of the largest in the City at this time. It would be all too possible, given the size of the program, to run into problems very quickly. The Chair had therefore proposed that the Committee receive a report on risk-management and controls with respect to the capital program and thereafter receive a quarterly report tracking project costs against budget. Ms Brown had kindly undertaken to prepare those reports. Ms Brown anticipated that the report on controls and the first quarterly report would be available for the next meeting on November 26.

10. Enrolment Audit, 2002-03

The Committee received, for information, the enrolment audit for 2002-03.

11. Report of the Administration

(a) Financial Briefings to the Business Board

Mr. Chee reported that the Chair of the Business Board had asked him, working with the Vice-President and Provost, to prepare briefings for the Board on various financial matters to enable the Board to have a better overview of broad financial matters at the University and to encourage the Board to focus on larger, strategic issues. Those briefings were scheduled to take place at the beginning of each Board meeting, and members of the Audit Committee might well find it worthwhile to attend.

(b) Long-Range Budget Guidelines

In response to the Chair's question, Mr. Chee said that the Vice-President and Provost had issued a draft of her new academic planning white paper. He had reviewed the section dealing with resources and had found it to be entirely satisfactory from a financial point of view. The White Paper would be finalized and then the financial aspects would be translated into detail

11. Report of the Administration (Cont'd)

(b) Long-Range Budget Guidelines (Cont'd)

in new, six-year, Long-Range Budget Guidelines. Mr. Chee had been asked to review the various financial assumptions including the projection of investment returns. Considerable uncertainty had developed as a result of the recent provincial election. The new governing party had promised to freeze tuition fees and there was uncertainty whether the Government would replace the lost revenue by increasing its grants. The University was in the position of having to consider various contingency plans in order to be able to react quickly to possible outcomes. If the Committee wished to consider the financial prudence of the Guidelines, it would be appropriate to invite the officers responsible for budgeting to attend the Committee.

(c) Internal Audit Department Budget

Mr. Charpentier reported on the outcome of the Committee's representation that the Internal Audit Department be exempted from the across-the-board budget reduction for the 2003-04 fiscal year. He was pleased to report that the Department's budget had been restored.

12. Date of Next Meeting

The Chair reminded members that the next regular meeting was scheduled for **Wednesday, November 26, 2003 at 4:00 p.m.**

The meeting adjourned at 6:45 p.m.

Secretary	Chair

February 18, 2004