



Risk & Audit Committee

Agenda Item 5b

November 15, 2023

Item Name: Review of Independent Auditor's Management Letter

Program: Audit Services

Item Type: Action

Recommendation

Approve the CalPERS Board of Administration's (Board) Independent Financial Statement Auditor's (Independent Auditor) Management Letter for the fiscal year ended June 30, 2023.

Executive Summary

The draft Management Letter, prepared by the Board's Independent Auditor, BDO USA, (BDO), includes comments and recommendations related to strengthening internal controls over financial reporting based on the audit of the June 30, 2023 financial statements. Management's concurrence, response, and proposed corrective actions to the observations and recommendations are included in the draft Management Letter. In addition, management reported that the prior year observation was resolved.

Strategic Plan

This item is not a specific product of the strategic plan. Government Code section 20228 requires the board to annually employ a certified public accountant, who is not in public employment, to audit the financial statements.

Background

BDO completed its audit of CalPERS Basic Financial Statements for the fiscal year ended June 30, 2023, as required by Government Code section 20228. In connection with the audit of the financial statements, BDO prepared a draft Management Letter that includes comments and recommendations to enhance internal controls over financial reporting (Attachment 1).

The Management Letter is considered a draft until it is approved by the board and subsequently signed by BDO. The signed Management Letter will be distributed to the board, executive team, and senior management.

Analysis

Consistent with the Office of Audit Services Audit Resolution Policy, the status of the Management Letter observations will be reported to the Risk and Audit Committee until management has resolved each noted observation. The tables below summarize the current and prior year observations.

Table 1 – Current Year Observations

Observations	Description
1 (FY 2022-23)	<p>BDO observed that seven developers of the Automated Real Estate Investment System (AREIS) have security administrative access to the database of AREIS. The database administrative access role provides users with the ability to deploy changes directly to the system without oversight.</p> <p>We observed the users with database security administrative access have full access (read, write, and edit) to the database. This results in a segregation of duties conflict because it provides the individual with the potential ability to modify the report logic within the database without approval. Although CalPERS has segregated developers and deployers on the application level, having full access to the database can bypass the system functionality, which results in a segregation of duties conflict. Additionally, no audit is being performed of the system change log nor database log-in access report to check for and investigate anomalies.</p> <p>Management has removed the developer group from the database. To strengthen the change management control environment, it is recommended that the change logs be reviewed on regular basis for appropriateness by an individual who does not have deploy access nor database rights to AREIS.</p>
2 (FY 2022-23)	<p>Each year the System estimates the amount of liabilities associated with the long-term Care Fund future liabilities. Recently, there was a class action lawsuit settlement that impacted the probability, timing, and nature of those future liabilities. Generally accepted accounting principles require changes in estimates of claim costs to be recognized in the period those estimates are changed. In the draft financial statements, management's estimated long-term settlement liability balance was correct and supported, however the offsetting impact to other accounts as a result of changes were not.</p> <p>BDO determined this error resulted from a material weakness in internal controls over financial reporting, specifically, the control surrounding reviewing the appropriate accounting and presentation of estimates related to the estimated settlement liability for the Long-Term Care Fund. The initial entry was recorded without properly considering all current information including details the settlement will have on future plan participation.</p> <p>The error had a material effect on the financial statements of the Long-Term Care Fund and overstated the long-term future policy benefits liability and related expenses. The adjustment to correct the impact was proposed by BDO and corrected by management.</p>

We recommend management implement a control for significant and unusual transactions where management ensures they obtain and consider all related information when assessing the appropriateness of accounting conclusions.

Table 2 – Status of Prior Year Observation

Observation	Description	Status
1 (FY 2021-22)	BDO observed that the proceeds receivable related the secondary sale of certain private equity investments were inappropriately recorded in Global Equity Securities instead of Investments Receivable. Although this classification error was not material either quantitatively or qualitatively, the reclassification was proposed by BDO and corrected by management. This error and the subsequent correction had no impact on total investments or total additions but only a change within the correct financial statement line item.	Resolved

Budget and Fiscal Impacts

The fee for the basic financial statements audit is anticipated to total \$1,061,360¹ and \$394,390 for the Governmental Accounting Standard Board (GASB) Statement No. 75 audits. Funding was already identified within budgetary resources as is consistent with the board approved contract.

Benefits and Risks

The primary benefit of approving the draft Management Letter is to assist CalPERS in meeting its fiduciary responsibilities to plan participants by ensuring the effectiveness of controls over financial reporting designed to prevent or timely detect errors that could result in material misstatements in the financial statements. The risk of not implementing recommendations is limiting the timely detection, prevention, or correction of material misstatements in the financial statements.

¹ This amount does not include the \$1,194,250 fee for GASB 68 audits.

Attachment

Attachment 1 – Management Letter (including CalPERS management’s responses),
prepared by BDO for the fiscal year ended June 30, 2023

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