



## Agenda Item 6a

March 17, 2014

**ITEM NAME:** External Auditor Management Letter

**PROGRAM:** Audit Services

**ITEM TYPE:** Action

### **RECOMMENDATION**

Approve the Draft Management Letter as prepared by Macias Gini & O'Connell LLP for the year ended June 30, 2013.

### **EXECUTIVE SUMMARY**

The Draft 2013 Management Letter, prepared by Macias Gini & O'Connell LLP, identifies a material weakness and a significant deficiency in controls over financial reporting as well as opportunities for strengthening internal controls and operating efficiency. Macias Gini & O'Connell LLP discussed the observations and recommendations in the Draft Management Letter with management who have concurred with the observations and prepared a response to each recommendation. Management has appropriately resolved a number of prior year comments and recommendations. Management's responses are included in this Draft Management Letter.

### **STRATEGIC PLAN**

This item is not a specific product of the Strategic Plan.

### **BACKGROUND**

The Board of Administration's independent external financial statement auditor, Macias Gini & O'Connell LLP, completed its audit of CalPERS Financial Statements as of and for the year ended June 30, 2013 as required by Government Code section 20228. The Board of Administration approved the basic financial statements on November 20, 2013. In connection with the audit of the financial statements, Macias Gini & O'Connell LLP prepared a Management Letter that includes observations and recommendations to enhance accounting and administrative internal controls as well as operational processes (Attachment 1). The Draft Management Letter also includes updated status on prior year observations.

The Management Letter is considered a draft until it is accepted by the Board of Administration and subsequently signed by Macias Gini & O'Connell LLP. The signed Management Letter will be distributed to the Board of Administration, executive staff and senior management.

**ANALYSIS**

Consistent with the Risk and Audit Committee’s Audit Resolution Policy, the status of the observations in the 2013 Management Letter will be reported to the Risk and Audit Committee until management has satisfactorily resolved each noted observation and Macias Gini & O’Connell concurs that corrective action has been implemented.

Table 1 below summarizes current year findings and observations. The page numbers referenced correspond to Attachment 1 of this agenda item.

Table 1

Issue Number	Summary of Current Year	Management Letter Page Number
	<b>Current Year Material Weakness</b>	
2013-1	Completeness and Accuracy of Investment Related Disclosures – Deposit and Investment Risk Disclosures (GASB 40) and Accounting and Reporting for Derivative Instruments (GASB 53)	3-5
	<b>Current Year Significant Deficiency</b>	
2013-2	Internal Controls Over Accounting and Financial Reporting	6-8
	<b>Current Year Other Comments and Recommendations</b>	
Obs.1	Other Post-Employment Benefits (OPEB) Liability Allocation	9
Obs.2	Member Census Data – Corrections in my CalPERS	10
Other Matter	Implementation of New Accounting and Financial Reporting Standards - GASB 67 and 68	11

Table 2 below summarizes prior year findings and observations for which progress has been made, but are still not fully resolved.

Table 2

Issue Number	Summary of Prior Year	Management Letter Page Number
	<b>Prior Year Significant Deficiencies</b>	
2012-1	Completeness and Accuracy of Investment Related Disclosures	12-13
2012-2	Account Analysis and Financial Reporting—unique transactions identified but account analysis needs improvement.	14-15
2012-3	Implementation of my CalPERS, items (a); (b); (c)—in process of being implemented	16-20
	<b>Prior Year Observations</b>	
Obs.2	Investment Commitment Disclosures. Automated Real Estate Investment System (AREIS) – Implemented, but noted input errors.	22-24
Obs.4	Self-Funded Healthcare Enrollment Reconciliation—implemented reconciliation procedures but need required timelines to complete the reconciliation.	25-26

Table 3 below shows prior year observations for which management has fully implemented corrective action. MGO has now closed these items so they will not appear on future reports.

Table 3

Issue Number	Summary of Observations Fully Resolved	Management Letter Page Number
2011-2012 Obs.1	Investment Classification	21
2011-2012 Obs.3	Internal Controls Over Benefit Processing	25
2011-2012 Obs.5	Access to Programs & Data	27
2010-2011 Obs.2	Reconciliation of Benefit Payments	27-29
2008-2009 Obs.4	Real Estate Appraisals	29-33

**BENEFITS/RISKS**

The primary benefit of approving the Draft Management Letter is that appropriate corrective action to the noted observations will result in significant improvement of internal controls over financial reporting. If not mitigated, the risk is that internal controls over financial reporting may not prevent, detect or correct misstatements on a timely basis. Additional benefits and potential risks include the following:

Benefits:

- Fulfill CalPERS fiduciary duty to members and comply with Government Code 20228.
- Document a formal record of CalPERS financial activities in compliance with Generally Accepted Auditing Standards.
- Enhance financial transparency and accountability over activities of the organization.
- Ensure accurate and value-added CalPERS financial information in the State Comprehensive Annual Financial Report.
- Provide timely, relevant, reliable and objective financial information to users of the financial statements.
- Disclose the claims and changes to the funds and economic resources.

Risks:

- If financial reporting is not accurate, the Board could execute decisions based on unreliable or outdated financial information.
- Management may lack financial reports to properly control and evaluate daily operations.
- Reputational risk exposure increases due to financial statement errors and misstatements.
- Delayed financial statements may negatively impact future benefits, investment decisions, and jeopardize the sustainability of funds.

**ATTACHMENT**

Attachment 1 – Draft Management Comments and Recommendations, prepared by Macias Gini & O’Connell LLP as of and for the fiscal year ended June 30, 2013.

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MARGARET JUNKER, Chief  
Office of Audit Services

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GINA M. RATTO  
Interim General Counsel