CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Comments and Recommendations

Fiscal Year Ended June 30, 2013

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Comments and Recommendations

Fiscal Year Ended June 30, 2013

TABLE OF CONTENTS

Page(s)

Transmittal Letter 1-2

Material Weakness 3-5

Significant Deficiency 6-8

Other Comments and Recommendations 9-10

Other Matter 11

Status of Prior Year Significant Deficiencies 12-20

Status of Prior Years Comments and Recommendations 21-33

DRAFT

February 5, 2014

To the Risk and Audit Committee of the
California Public Employees' Retirement System
Sacramento, California

In planning and performing our audit of the financial statements of the fiduciary activities and the proprietary activities of the California Public Employees' Retirement System (the System or CalPERS) as of and for the fiscal year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America, we considered CalPERS' internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CalPERS' internal control. Accordingly, we do not express an opinion on the effectiveness of CalPERS' internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a deficiency in internal control that we consider to be a material weakness and another deficiency that we consider to be a significant deficiency.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiency identified as item 2013-1 in the Material Weakness section of this report to be a material weakness.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency identified as item 2013-2 in the Significant Deficiency section of this report to be a significant deficiency. The status of the prior year significant deficiencies is included in the Status of Prior Year Significant Deficiencies section of this report.

In addition, during our audits in the current and prior fiscal years, we also became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The current year comments are included in the Other Comments and Recommendations section of this report. The status of the prior year comments is included in the Status of Prior Years' Comments and Recommendations section of this report.

CalPERS' written response to the comments and recommendations described in the Material Weakness, Significant Deficiency, and Other Comments and Recommendations sections of this report has not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

We would like to thank CalPERS' management and staff for the courtesy and cooperation extended to us during the course of our engagement.

This communication is intended solely for the information and use of management, the Board of Administration, and others within CalPERS and is not intended to be and should not be used by anyone other than these specified parties.

Sacramento, California

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Material Weakness
Fiscal Year Ended June 30, 2013

2013-1: Completeness and Accuracy of Investment Related Disclosures

Our audit procedures detected numerous errors in the investment risk disclosures in the draft financial statements. Deficiencies in the design and effectiveness of internal controls over financial reporting and insufficient knowledge of the accounting standards and the System's investment structure result in a reasonable possibility that a material misstatement of the System's financial statements will not be prevented, or detected and corrected, on a timely basis. As a result, internal controls over financial reporting did not ensure the proper reporting of investment related disclosures. The following errors, along with the errors described in prior year item 2012-1, are the result of a material weakness in internal control. Though individually certain errors were not material to the System's overall financial statements, the errors in the aggregate were deemed material to the financial statements.

1. Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) mortgage pass-through securities were originally disclosed as having Moody's credit quality ratings of Aaa when in fact, certain issues of these securities are not rated by Moody's or other nationally recognized statistical rating organizations (NRSROs).The original Aaa rating was provided by the custodian bank due to the perceived implicit guarantee of the U.S. government for these securities. The accounting standards require the rating disclosure of the debt investment rather than the issuer. For instances in which the debt investment is unrated but the issuer is rated, governments should indicate that the debt investment is unrated. The disclosure was subsequently revised to properly reflect the GASB Statement No. 40 credit risk disclosure requirements for the FNMA and FHLMC mortgage pass-through securities as not rated by NRSROs.

2. Commercial paper and U.S. Treasury bill investments held in the System's unitized pool, which are classified as debt securities in the financial statements, were originally excluded from the GASB Statement No. 40 credit risk and interest rate risk disclosures. Commercial paper is an unsecured promissory note issued primarily by corporations for a specific amount and maturing on a specific day. U.S. Treasury bills are short-term government securities issued for a specific amount and maturing on a specific day. GASB Statement No. 40 specifically requires that interest rate risk and/or credit risk disclosures be presented for investments such as U.S. Treasury bills, corporate bonds, and commercial paper. The accounting standard specifically exempts obligations of the U.S. government from the credit risk disclosure requirements; however, it is the System's practice to present obligations of the U.S. government as "N/A" in the credit risk disclosure table, which represents securities not subject to GASB Statement No. 40 disclosure requirements. The disclosures were subsequently revised to properly present commercial paper and U.S. Treasury bills.

DRAFT

2013-1: Completeness and Accuracy of Investment Related Disclosures (Continued)

3. Investments in State Street Global Advisors' commingled funds were originally disclosed as having no effective duration in the interest rate risk disclosures, although weighted average maturity information was available. GASB Statement No. 40 requires governments that report debt investment pools (such as bond mutual funds and external bond investment pools) to use one of the following methods: segmented time distribution, specific identification, weighted average maturity, duration, or simulation model. The GASB Comprehensive Implementation Guide states "Bond funds generally own many debt investments with differing maturities, so a bond fund reports duration or average maturity - the average of all the debt investment maturities in a fund's portfolio, weighted by the par value of each investment". The disclosure was subsequently revised to properly reflect the GASB Statement No. 40 interest rate risk requirements using the weighted average maturity method for bond funds.

4. CalPERS' investments include collateralized mortgage obligations and mortgage pass-through securities, which are highly sensitive to interest rate changes in that they are subject to early payment in a period of declining interest rates. The resulting reduction in expected total cash flows affects the fair value of these securities. GASB Statement No. 40 specifically requires disclosure of investments that are highly sensitive to changes in interest rates. However, the collateralized mortgage obligations and mortgage pass-through securities were not originally identified as such in note disclosures. The disclosure was subsequently revised to properly reflect GASB Statement No. 40 risk disclosures for investments that are highly sensitive to interest rate changes.

5. U.S. Treasury bill investments were originally included in the money market funds line item in the GASB Statement No. 40 interest rate risk disclosure for securities lending collateral. The accounting standard specifically requires investment disclosures to be organized by investment type, such as U.S. Treasuries, corporate bonds, or commercial paper. Dissimilar investments should not be aggregated into a single investment type. The disclosure was subsequently revised to properly present U.S. Treasury bill investments separate from money market funds.

6. U.S. Treasury bill investments were originally disclosed as having Moody's credit quality ratings of P-1 in the GASB Statement No. 40 credit rate risk disclosure for securities lending collateral. The accounting standard specifically exempts obligations of the U.S. government from the credit risk disclosure requirements. The disclosure was subsequently revised to reflect U.S. Treasury bills as "N/A" in the credit risk disclosure table which indicates those investments are not subject to GASB Statement No. 40 credit risk disclosure requirements.

DRAFT

2013-1: Completeness and Accuracy of Investment Related Disclosures (Continued)

7. The Fiscal Services Division prepares an excel spreadsheet to reconcile the fair value of debt investments in the GASB Statement No. 40 disclosures to the global debt securities amount in the financial statements. The GASB Statement No. 40 disclosures should include all debt investments at fair value regardless of the classification within the financial statements. The global debt securities line item in the statement of fiduciary net position and the statement of proprietary net position present the fair value of non-unitized investments and the net asset values for investments in the unitized pools, which include accruals in the related unitized portfolios. In addition, certain debt securities are classified as inflation assets in the statement of fiduciary net position and the statement of proprietary net position. The original reconciliation spreadsheet did not properly reconcile the GASB Statement No. 40 disclosures and financial statement amounts. The spreadsheet was subsequently revised to properly reconcile the fair value of debt securities between the disclosures and the financial statements.

We noted the following error during the fiscal year ended 2012/2013 audit of the GASB Statement No. 53 derivative disclosures:

1. In three instances, the original disclosures improperly reflected fair values for derivative instruments that had no fair values at year-end. The original underlying detail data provided by the custodian bank reflected zero fair values. These errors were subsequently revised in the GASB Statement No. 53 derivative disclosures.

Recommendation:

The System's financial reporting process should include internal controls to ensure the completeness and accuracy of investment related data. Given the complexity of the accounting standards and the System's investment transactions, we continue to recommend that the investment risk disclosures be prepared and reviewed by personnel who possess proper technical knowledge of the accounting standards and the System's investment structure to ensure the conformity of the investment disclosures to the financial reporting requirements.

Management Response:

Management concurs and has already taken the steps to address this issue. We are performing interim reviews of GASB 40 and GASB 53 disclosure data to identify issues by evaluating this information using another source (BlackRock). We are meeting with State Street regularly to discuss the differences and determine solutions to these issues. We will continue to ensure that the data is accurate from State Street Bank and work with them to ensure quality assurance processes are implemented. We will be performing a comprehensive review of all CalPERS underlying investments. We will be working closely with the Investment Office to identify any new investment types, which are subject to GASB 40 and GASB 53 risk disclosures. We will continue to gain an understanding of the risk characteristics of different investment types.

We have also moved the GASB analysis and reporting functions from Trust Accounting I to the Financial Reporting Unit who is responsible for GASB related disclosures. We will be moving the reporting that is currently completed in Trust Accounting II to Financial Reporting to ensure consistent, accurate and complete reporting for all the Trusts related to GASB 40 and GASB 53.

By June 30, 2014 all new procedures for GASB 40 and GASB 53 will be implemented. Transition of workload to the Financial Reporting Unit will also be complete.

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiency
Fiscal Year Ended June 30, 2013

2013-2: Internal Control Over Accounting and Financial Reporting

Our audit procedures detected several errors in the reported amounts and classification in the draft financial statements. The System's current accounting and reporting process is insufficient to prevent, or detect and correct, financial statement misstatements in a timely manner. Although individually the errors were not deemed material to the System's overall financial statements, the errors in the aggregate were considered significant to the financial statements. The following accounting and financial reporting errors were noted during the audit:

Public Employees' Retirement Fund:

1. Administrative expenses payable were reported as Retirement and Other Benefits Payable rather than Other Program Liabilities in the financial statements. This classification error was not considered material to the overall financial statements and was not corrected in the audited financial statements.

IRC 457 Deferred Compensation Fund:

2. The Placer County 401(k) plan activities were improperly reported in the IRC 457 Deferred Compensation Fund. The Placer County 401(k) plan activities were subsequently reversed from the IRC 457 Fund financial statements but were not properly presented in an agency fund; this error was communicated in the Report to the Risk and Audit Committee in Schedule I, Summary of Uncorrected Financial Statement Misstatements.

3. The original member contribution receivable was recorded twice as the Fiscal Services Division did not adjust its year-end accrual process in light of system reporting enhancements associated with the implementation of my|CalPERS. This error was subsequently corrected in the IRC 457 Deferred Compensation Fund financial statements.

Contingency Reserve Fund (CRF)

4. Premiums received by the CRF agency fund from the State in advance of the due date were originally reported as Due to Health Carriers. A portion of the advance premiums related to Health Care Fund (HCF) activities and should have been reported in the HCF as interfund receivables (Due from Other Funds) and Unearned Premiums payable. This error was corrected in the CRF agency and HCF financial statements. In addition, approximately $16 million of advance premiums received from public agencies was properly reported as Due to Health Carriers in the CRF agency fund; however, due to current system constraints, the Fiscal Services Division was unable to identify the portion of the $16 million of advance premiums that should have been reported in the HCF.

DRAFT

2013-2: Internal Control Over Accounting and Financial Reporting (Continued)

Health Care Fund:

5. Insurance Premiums & Claims Payable and Unearned Premiums Payable were originally reported as Other Program Liabilities. These errors were corrected in the financial statements.

6. Effective January 1, 2013, CalPERS partnered with its Pharmacy Benefit Manager (PBM) to provide a custom Medicare Part D prescription drug plan, the Employer Group Waiver Plan (EGWP). Under the EGWP, CalPERS received premium subsidies, rebates and coverage gap discounts from the Federal government. EGWP subsidies were originally reported as Premium Revenues; this error was subsequently corrected and reported as Federal Government Subsidies in the audited financial statements.

7. Loan Receivables were originally reported as Other Receivables, the current and long-term balances were not properly reported, and the loans receivable was not disclosed in the notes to the basic financial statements. There errors were subsequently corrected in the financial statements.

Long-Term Care Fund:

8. Unearned Premiums were originally reported as Other Program Liabilities. This error was subsequently corrected in the financial statements.

Lastly, we noted the following error, which impacted multiple reporting funds:

9. Unapplied general ledger accounts were originally reported as Other Program Liabilities rather than being reported to the respective Receivable accounts. These errors were subsequently corrected in the financial statements.

Recommendation:

Internal controls over financial reporting should include procedures to ensure that financial statement amounts are accurate and properly classified. Given the complex nature of the System, we recommend that the accounting and financial reporting transactions be processed and reviewed by personnel who possess an appropriate level of technical knowledge of the accounting standards and understanding of the System's accounting and financial reporting activities.

Management Response:

Management concurs and has already and will continue to implement solutions to better track accounting changes and reporting requirements. We have begun to work on monthly financial reports to analyze changes on a month to month basis in our accounting areas. We have started quarterly reporting which is a year to date report and compares to prior year information. We have also started to work with the program areas and ITSB to gather programmatic data to use when evaluating financial data. We continue to review and analyze this information to ensure the data is accurate and correct, and correlates to our financial data.

DRAFT

2013-2: Internal Control Over Accounting and Financial Reporting (Continued)

Management Response (Continued):

CalPERS has hired a Controller in October 2013 to oversee both the accounting areas and the financial reporting within the organization. This position is responsible for reviewing all financial reporting, both monthly and quarterly, as well as being responsible for ensuring the proper treatment of new accounting standards. The Controller is responsible for bridging the gap between financial reporting and program accounting to make sure that they communicate and collaborate on any issues that arise. In additional, functional changes have been implemented within this area, the Financial Reporting Unit is accountable for the information within the financial statements while the other accounting areas are responsible for the accounting entries. The Financial Reporting Unit is analyzing any accounting changes to ensure this information is represented accurately within the financial reports. Monthly meetings will be held among these areas to ensure cross collaboration is occurring. Topics will include discussion of any new chart of accounts, accounting process changes, analysis from quarterly and monthly financial and new reporting requirements.

These changes have already begun, and we will continue to develop our reporting sections skills and we will have a fully implemented quarterly and monthly reporting process by June 30, 2014.

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations
Fiscal Year Ended June 30, 2013

Fiscal Year 2012/2013 Observation #1 – OPEB Liability Allocation

We noted the System's liability for other postemployment benefits (OPEB) is not allocated to the Public Employees' Long-Term Care Fund. We also noted that the Public Employees' Contingency Reserve Fund (CRF Proprietary Fund) reports a material OPEB liability balance. The System's OPEB liability should be allocated to each plan (or fund) based on a reasonable and consistently applied allocation method.

The State of California (the State), as an employer, provides retired State employees with certain OPEB benefits such as health care and dental benefits, under a single-employer defined benefit plan. As a State agency, CalPERS provides funding for the State's OPEB benefits. CalPERS' funding is based on the amount determined by the State on a pay-as-you-go basis. CalPERS records its share of the net OPEB obligation as determined by the State Controller's Office (SCO) based on the most recent State of California actuarial valuation report. Given the current allocation method, the Long-Term Care Fund does not share in the cost of OPEB and the CRF Proprietary Fund will continue to experience operating losses each year and its net position will continue to decrease.

Recommendation:

CalPERS should re-evaluate the fund allocation provided by the SCO to ensure the allocation is appropriate for CalPERS' accounting and financial reporting purposes. With the implementation of GASB Statement No. 68 *Accounting and Financial Reporting for Pensions - An Amendment of GASB Statement No. 27* effective for fiscal year 2015, CalPERS should also determine the allocation method for pension expense and the net pension liability, which may include CalPERS as an employer. Allocations should be made to only those funds that will actually pay the benefits.

Management Response:

Management concurs and has already begun discussions with the State Controller's Office (SCO) to better understand the treatment of the OPEB liability and how it is calculated. We will work with SCO to explain the concerns, determine if a solution can be reached and prepare an implementation plan. We recognize there are external dependencies in working with other state agencies in obtaining a satisfactory resolution and will examine our required reporting options. We will have our discussion with the State Controller's Office by June 30, 2014. There cannot be timeline for implementation of a solution until we have been able to determine what that solution could entail.

DRAFT

Fiscal Year 2012/2013 Observation #2 – Member Census Data

During our audit, we noted the ACTO currently does not have a formal process to communicate to other CalPERS offices and units changes made to members' census data in the AVS or to verify that the related changes are made in my|CalPERS by the other appropriate CalPERS offices and units. Effective for the fiscal year ended June 30, 2013, the Actuarial Office (ACTO) transfers member census data generated from my|CalPERS into the Actuary Valuation System (AVS) to prepare the annual actuarial valuation reports for participating employers. Prior to the preparation of the actuarial valuation reports, a reconciliation is performed, which includes a comparison of member census data to the prior year. In some instances, discrepancies in members' census data exist, which can result in the ACTO making certain changes to the members' census data in the AVS. Certain changes were not communicated to other CalPERS offices and units, which resulted in immaterial discrepancies in members' census data between my|CalPERS and AVS.

Recommendation:

We recommend that management establishes a formal process to ensure changes to members' census data are properly communicated to affected offices and units. The process should include a subsequent review by ACTO personnel to ensure appropriate changes are also reflected in my|CalPERS.

Management Response:

The Actuarial Office concurs with the observation and recommendation to formalize a process to ensure necessary changes to members' census data are communicated to the appropriate areas for correction. The Actuarial Office performed the first annual valuation utilizing data from the my|CalPERS system for fiscal year-end, June 30, 2012. We utilized two processes to communicate adjustments of member census data: 1) ClearQuest to log data issues to the Data Corrections team and 2) the my|CalPERS Workflow system to direct work requests to the appropriate area. We will formalize this procedure to ensure the member's census data is properly communicated, monitored and validated by the Actuarial Office. The Actuarial Office will implement these actions by December 20, 2014.

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Matter
Fiscal Year Ended June 30, 2013

The following describes significant changes in pension accounting and reporting standards that we are actively discussing with the System's management. We recognize that management is currently evaluating the impacts of the new standards and, as such we did not request that management provide a written response.

Implementation of New Accounting and Financial Reporting Standards

The System is required to implement GASB Statement No. 67, *Financial Reporting for Pension Plans - An Amendment of GASB Statement No. 25* for the fiscal year ending June 30, 2014. The System is also required to provide its participating employers actuarial information in accordance with the requirements of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions- An Amendment of GASB Statement No. 27*.

Fiscal Services Division should work with other Divisions and Branches, such as the Actuarial and Legal Offices to develop a work plan for the implementation of new accounting and financial reporting standards. An effective work plan should include the following essential elements:

- Assign staff with sufficient experience to evaluate the new standards and determine the applicability to the System;
- Identify key personnel and data needed for the implementation;
- Establish a timeline for the implementation;
- Provide training to key personnel throughout the System;
- Apply the new standards to interim data, or create a template that reflects the format in which data will be presented;
- Document the relevant provisions and the conclusions reached in a formal memorandum;
- Draft revisions to the financial statements for management's and the external auditor's review;
- Determine, with input from participating employers, the form and content of additional data to be provided to participating employers and evaluate the need for audit assurance.

DRAFT

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies
Fiscal Year Ended June 30, 2013

2012-1: Completeness and Accuracy of Investment Related Disclosures

We previously reported as observation #1 in fiscal year 2010/2011 that the Fiscal Services Division lacks a formal process to verify that investment disclosure data provided by the custodian bank agrees with the related amounts reported in the general ledger and other supporting documentation. We noted several errors in the draft investment disclosures during the 2011 audit.

In fiscal year 2011/2012, we noted the following errors during our audit of the Governmental Accounting Standards Board (GASB) Statement No. 40 investment risk disclosures:

1. Federal Home Loan Mortgage Corporation (FHLMC) securities were originally disclosed as not being subject to the GASB Statement No. 40 credit risk disclosure requirements. GASB Statement No. 40 specifically exempts from the credit risk disclosure requirements securities that are explicitly guaranteed by the U.S. government. The FHLMC securities are not explicitly guaranteed by the U.S. government and therefore are subject to the disclosure requirements. The disclosure was subsequently revised to properly reflect the GASB Statement No. 40 credit risk disclosure requirements for the FHLMC securities.

2. Short-Term Investment Fund (STIF) investments held in the System's unitized pool, which are classified as debt securities on the financial statements, were originally excluded from the GASB Statement No. 40 credit risk and interest rate risk disclosures. GASB Statement No. 40 specifically requires that credit risk and interest rate risk disclosures be presented for pooled investments such as STIF investments. The disclosure was subsequently revised and the required disclosures were made for the STIF investments.

In fiscal year 2011/2012, we noted the following errors during our audit of the GASB Statement No. 53 derivative disclosures:

1. In three instances, the original disclosures improperly reflected fair values for derivative instruments that had no fair values at year-end. These errors were subsequently revised in the GASB Statement No. 53 derivative disclosures.

2. The draft disclosures included four instances in which the notional dollars for certain derivative instruments were originally reported in notional units, and two instances in which the derivative instruments were reported in notional dollars rather than in notional units. These errors were subsequently revised in the GASB Statement No. 53 derivative disclosures.

DRAFT

2012-1: Completeness and Accuracy of Investment Related Disclosures (Continued)

Given the complexity of the accounting standards and the System's investment transactions, we recommend that these disclosures be prepared and reviewed by personnel who possess proper technical knowledge of the accounting standards and comprehension of the System's investment structure and transactions. Furthermore, Investment Accounting personnel in the Fiscal Services Division should validate the completeness and accuracy of investment disclosure data provided by the custodian bank.

Management Response:

Fiscal Services Division concurs with the recommendation to validate the completeness and accuracy of investment disclosure data provided by the custodian bank with the preparation and review of disclosures by Fiscal Services staff with the necessary technical knowledge due to the complexity of the data. Fiscal Services Division will strengthen procedures to validate the completeness and accuracy of investment disclosure data provided by the custodian (State Street Bank). The Fiscal Services Division will work with State Street Bank to implement a Service Level Agreement to document roles and responsibilities to ensure complete and accurate information from State Street Bank. There will be a closer collaboration of Investment Office and Fiscal Services staff to share investment expertise that better supports the validation of the disclosure data provided by the custodian bank. In addition, Fiscal Services Division staff has implemented a secondary level of review by management and will revisit the current timelines to ensure we leave adequate time to perform our due diligence before the disclosures are submitted.

Fiscal Services Division continues to partner with State Street Bank in offering staff access to investment training courses and workshops in order to expand staff knowledge and expertise. As well, we have enrolled five of our staff in the INVO Smart Training program to enhance their technical knowledge through direct investment training. Fiscal Services anticipates the procedures and secondary level of review to be in place for the upcoming fiscal year-end close activities beginning July 1, 2013 and concluding in October 2013.

Fiscal Year 2012/2013 Status:

This recommendation has not been implemented. Refer to item 2013-1 in the Material Weakness section for the current year findings and recommendations.

DRAFT

2012-2: Account Analysis and Financial Reporting

As part of our audit, we requested and the Fiscal Services Division provided comparative trial balances for all funds along with an analysis of significant or unusual changes in account balances and financial statement line items. We utilize the analysis to identify significant or unique transactions and to ensure that financial transactions are properly classified and recorded. The analysis should also support management's discussion and analysis (MD&A) in the financial statements. Based on our review of the analysis, we noted the following errors and opportunities for improvement:

- There were several general ledger accounts and financial statement line items with unexpected or unusual changes from the prior year that were not properly analyzed and resolved by Fiscal Services personnel. We determined that the changes were due to the improper posting of transactions to certain general ledger accounts, which resulted in audit adjustments.

- The original account analysis and MD&A in the financial statements both described the changes between current year and prior year balances in dollar amounts and percentages but did not provide the reasons for the changes. Determining the reasons for significant changes is essential for ensuring the proper classification and recording of financial transactions and complying with financial reporting requirements.

The account analysis and MD&A should include a discussion of the reasons for significant or unusual changes in financial position and results of operations in the current year compared to the prior year. We recommend that the Fiscal Services Division's review and analysis of the comparative trial balances include an investigation of significant changes in financial position and results of operations. The investigation should include inquiries of key personnel in other Divisions to ensure a proper understanding of current year financial transactions and activities. Although the Fiscal Services Division is ultimately responsible for ensuring the completeness and accuracy of the financial statements, incorporating the unique perspectives of the personnel responsible for key activities would enhance the usefulness and improve users' understanding of the financial statements.

Management Response:

The Fiscal Services Division concurs with the observation and recommendation to:

1) Perform in-depth analysis on general ledger accounts and financial statement line items with unexpected or unusual changes.
2) Investigate significant changes in financial position and results of operation to obtain appropriate information to determine reasons and for inclusion in the MD&A.

The Fiscal Services Division will implement the recommended actions for the 2012/13 audit of the basic financial statements and note disclosures.

DRAFT

2012-2: Account Analysis and Financial Reporting (Continued):

Management Response (Continued):

Preliminary Implementation Plan:
By June 30, 2013, the Fiscal Services Division will take the following steps to address the issue:

1) Meet with key managers of various accounting units and program areas to discuss the issue, potential solutions, and steps to resolve the issue.

2) For the management's discussion and analysis, study the best practices by reviewing other pension funds' Comprehensive Annual Financial Reports (CAFR) and adopt them where appropriate and applicable.

The Fiscal Services Division will continue to work on account analysis in order to successfully and timely complete the CAFR by November 2013.

Fiscal Year 2012/2013 Status:

During the fiscal year 2012/2013 audit, we noted improvements over the analysis of general ledger accounts and management's discussion and analysis. However, the Fiscal Services Division should continue to enhance procedures in this area by reviewing and analyzing changes in account balances, with a focus on the reasons for the changes. The analysis should include inquiries of key personnel in other Divisions to ensure a proper understanding of current year financial transactions and activities.

Fiscal Year 2012/2013 Management Response:

Management concurs and has already and will continue to implement solutions to better track accounting changes and reporting requirements. We have begun to work on monthly to analyze changes on a month to month basis in our accounting areas. We have also started quarterly reporting which is a year to date report and compares prior year information. We have also started to work with the program and ITSB to gather programmatic data to compare with financial data. We continue to review and analyze this information to ensure the data is accurate and correct data is correlated with the financial data.

CalPERS has hired a Controller in October 2013 to oversee both the accounting areas and the financial reporting within the organization. This position is responsible for reviewing all financial reporting, both monthly and quarterly, as well as being responsible for ensuring the proper treatment of new accounting standards. The Controller is responsible for bridging the gap between financial reporting and program accounting to make sure that they communicate and collaborate on any issues that arise. In additional, functional changes have been implemented within this area, the Financial Reporting Unit is accountable for the information within the financial statements while the other accounting areas are responsible for the accounting entries. The Financial Reporting Unit is analyzing any accounting changes to ensure this information is represented accurately within the financial reports. Monthly meetings will be held among these areas to ensure cross collaboration is occurring. Topics will include discussion of any new chart of accounts, accounting process changes, analysis from quarterly and monthly financial and new reporting requirements.

These changes have already begun, and we will continue to develop our reporting sections skills and we will have a fully implemented quarterly and monthly reporting process by June 30, 2014.

DRAFT

2012-3: Implementation of my|CalPERS

The Pension System Resumption (PSR) Project has been a very large endeavor for the past few years. In fiscal year 2011/2012, the PSR project culminated with the implementation of the my|CalPERS system. The my|CalPERS system creates a "one-shop stop" for more than 50 legacy systems, and is used for Retirement Services, Benefit Services, Health Services, and Employer Payroll/Contribution Services. The implementation of my|CalPERS encompassed several go live dates for the different business areas and plans. As part of our audit, we reviewed the general and application controls of the my|CalPERS system, and, as appropriate, we performed tests of significant controls related to the major transaction streams. Our testing revealed the following:

a. Manual Overrides – All elements are editable in the system. Manual overrides are performed in the areas of benefit calculations, payroll adjustments, sick leave conversions, educational leave, and community property to name a few. In some instances, personnel do not rely on the new system calculations but rather utilize the legacy systems and manual spreadsheets to perform calculations and manually override the benefit amounts in the my|CalPERS system.

b. System Access – my|CalPERS application authorization roles should be periodically reviewed. IT general controls should ensure that information is properly secured, application access is granted to only authorized personnel, and user accounts are managed to enforce a proper segregation of duties. While proper user account provisioning and password controls have been implemented in the new my|CalPERS environment, and user authorization roles have been created, procedures are not yet established to periodically review user accounts and their associated roles to ensure they are up to date and enforce a proper segregation of duties.

c. my|CalPERS General Controls – IT general controls for systems acquisition, development and change management should ensure that system implementations maintain the integrity and completeness of the information as well as ensuring processing accuracy. While the vast majority of transactions are processing correctly in my|CalPERS, there are some errors in the areas of benefit payment processing in health benefit deductions, death benefits, and employer reporting. While management is confident that outstanding issues have been identified and are being addressed, the impact of the errors and effects on the financial information has not been quantified.

d. Data Query and Reporting Knowledge Transfer – The PSR project included the utilization of numerous external consultants. To date, there has not been an adequate transfer of knowledge as CalPERS personnel rely heavily on the external consultants to query data and to generate certain reports from the my|CalPERS system.

DRAFT

2012-3: Implementation of my|CalPERS (Continued)

CalPERS should enhance the following processes and controls:

a. Re-evaluate the data elements within my|CalPERS and reduce the reliance on manual overrides in the system, particularly the manual overrides that impact financial statement amounts. In the instances manual overrides are necessary, management should ensure that proper internal controls are in place for such manual overrides. Furthermore, personnel should discontinue the use of manual spreadsheets in calculating benefit payments and should refrain from manually overriding the benefits calculated by my|CalPERS.

b. The appropriate business unit managers, working with the application managers, should develop procedures for the periodic review and testing of my|CalPERS user accounts and their authorization roles to ensure they are up to date and enforce a proper segregation of duties. Documentation of the reviews should be maintained to substantiate the review process and corrections made. User roles and access rights should be evaluated to ensure that the access granted is critical to the performance of the employees' duties.

c. CalPERS Office of Audit Services should consider conducting a review to determine the possible quantity of transactions and dollar value of the outstanding processing issues that the my|CalPERS implementation team has identified. Based upon the dollar value of the processing issues, a determination should be made as to the resources to be dedicated to addressing the outstanding issues.

d. Develop a transition plan and conduct appropriate training to educate CalPERS personnel on the my|CalPERS system's data query and reporting functions and capabilities.

Management Response:

a. The Customer Services and Support (CSS) Branch concurs with the observation and recommendation. Since the new system has been implemented the total number of overrides has decreased significantly and occurs on only a small percentage of the total calculations performed. Some overrides will continue to be necessary due to employer reporting errors and data conversion gaps, to pay benefits accurately and timely. CSS will continue to evaluate the data elements within my|CalPERS in regards to performing necessary manual overrides and usage of manual spreadsheets in the calculation of benefit payments. CSS currently tracks, logs and documents each override.

   Preliminary Implementation Plan:

   - CSS will continue to reduce the reliance on manual overrides by implementing identified enhancements or correcting defects that lead to the use of manual overrides.

DRAFT

2012-3: Implementation of my|CalPERS (Continued)

Management Response (Continued):

- CSS will continue to reduce the usage of manual spreadsheets in calculating benefit payments as system enhancements and the correction of defects are applied.

- CSS will continue to enhance procedures and processes on the proper use and approval process for utilizing overrides. The Customer Services and Support System continues to monitor and plans a milestone evaluation at June 30, 2013.

b. CSS Branch concurs with the observation and recommendation and has developed a plan to ensure procedures for the review and testing of my|CalPERS user accounts and their authorization roles are up to date. CSS will document the reviews to substantiate the review process. CSS will evaluate user roles and access rights to ensure that the access granted is critical to the performance of the employees' duties.

Preliminary Implementation Plan:
CSS is coordinating a user access project team which includes representatives from the Enterprise Risk Management Division, Information Security Management Section and the Office of Audit Services. CSS expects to implement the already approved my|CalPERS user access project by June 30, 2013. Specifically, CSS and the project team will:

- Update and roll out Requester and Approver procedures.

- Develop and implement procedures to review, communicate, and revoke access for users who have not accessed the system in the last 90+ days.

- Identify and implement a new base group role that provides limited access to peripheral users. This will replace the current CalPERS Agent as the base role and will provide limited access to my|CalPERS data.

- Review existing group roles to determine appropriate permission sets that should be included for unit staff to perform responsibilities. This is designed to prevent the routine need for cross-divisional approvals for UARS requests (User Access Request System).

- Conduct a detailed review and analysis to identify and implement changes to group roles and permission sets at the UID (User Interface Design) level. This effort will better define the group roles and permission sets and limit access to only what is needed by the business area to perform their work. Once completed CSS will implement system changes needed to add, change or delete group roles and permission sets while updating the my|CalPERS Security Matrix.

DRAFT

2012-3: Implementation of my|CalPERS (Continued)

Management Response (Continued):

- Develop, document and implement a process for creating, modifying and deleting roles and permission sets.

c. The Office of Audit Services (OFAS) agrees with the recommendation. In the time since the financial statement audit, management has made significant continued progress in the areas noted. OFAS has included in its audit plan, and will continue to include, areas impacted by my|CalPERS, and to the extent the issues identified by the my|CalPERS implementation team have not already been addressed, OFAS will include an assessment of the impact of unresolved errors on financial information. OFAS plans to complete such reviews in stages and address all areas noted by June 30, 2014.

d. Specifically relating to the area of data reporting, as of January 31, 2013, the Information Technology Branch completed the planned knowledge transfer activities from external consultants to CalPERS staff. External consultants continue to 'work down' their queue of data requests to fulfill their contractual obligations. All new data requests are handled by CalPERS Data Reporting staff who continue to mature their workload capacity. Some new requests may be routed to external consultants, as appropriate, if they are part of their existing contractual obligations. Where applicable, additional knowledge transfer activities may be initiated when new needs arise, prior to the external consultants' departure. Information Technology Services Branch expects to complete this issue by June 30, 2014.

Fiscal Year 2012/2013 Status:

a. This recommendation is in process of being implemented. The System has compiled a report that lists the overrides and processes being investigated. The report details the benefit type, system-calculated amount, override amount, approvers and override date. As of June 30, 2013, there were 346 overrides listed in the report. While the report lists the approvers of the overrides, there is still no formal policy or documentation of the override approval process that details approver authority positions and levels of approval authority.

.

b. This recommendation is in process of being implemented. The System has developed account approver and requester procedures for account provisioning. A review of account roles and authorization is still being conducted to ensure user accounts allow only authorized transactions to be performed and the System enforces a proper segregation of duties. The System's management expects the reviews and updates to be completed by the end of calendar year 2014.

DRAFT

2012-3: Implementation of my|CalPERS (Continued)

Fiscal Year 2012/2013 Status (Continued):

c. During the fiscal year 2012/2013 audit, we noted my|CalPERS implementation errors pertaining to employer reporting have been addressed. OFAS completed a review of the Death Benefit process in fiscal year 2012/2013; the results revealed that my|CalPERS implementation issues have been resolved. An internal audit project for the health benefit area is included in OFAS' fiscal year 2013/2014 audit plan and the target completion date is June 30, 2014.

d. This recommendation has been implemented.

Fiscal Year 2012/2013 Management Response:

a. The my|CalPERS system change request to implement a unique secondary approver on all manual overrides is pending prioritization for a future my|CalPERS release. Each unit within the Benefit Services Division developed and documented manual override procedures and will continue enhancing certain override procedures. We will prioritize the related my|CalPERS changes by December 31, 2014. In the meantime, procedures will be enhanced by March 31, 2014.

b. The user access project has completed the activities identified in the plan to address the audit observation and are working to implement the my|CalPERS system changes required to better define current user access. The following activities have been completed as part of the user access project:
   - Updated my|CalPERS security role and system access procedures.
   - Eliminated inactive my|CalPERS user accounts and provided read only access to the CalPERS agent.
   - Mapped the unit processes within each Division, determined the user access needs, security roles and streamlined the approval process.
   - Reviewed and documented the Phase 1 user access changes.

   The user access project will continue with Phase 2 to implement further user access refinements in 2014.

c. Office of Audit Services completed its review of death benefits and employer reporting and did not find continued uncorrected errors caused by my|CalPERS processing. The Office of Audit Services had included a review of health deductions within the new my|CalPERS environment in its 2012-2013 and 2013-2014 Audit Plans; but significant functionality was still being implemented during the calendar 2013 timeframe, so the audit was deferred as requested by management. In January 2014, the appropriate my|CalPERS tools were implemented to capture health deductions. We anticipate sufficient data will be available to conduct a health deductions review by late spring and Audit Services plans to address this area by June 30, 2014.

DRAFT

Fiscal Year 2011/2012 Observation #1 – Investment Classification

Certain investment portfolios are unitized in order to commingle the investments of the various plans. The unitized portfolios are categorized based on the primary nature of the underlying securities (i.e. domestic or international fixed income, and domestic or international equity unitized portfolios). During our audit, we noted inconsistencies in the way in which the Public Employees' Retirement Fund (PERF) reported unitized pool investments compared to the way in which the affiliated funds reported those same investments. The PERF classified the domestic and international pool investments based on the pools' underlying securities. In contrast, the affiliated funds properly reported the investments based on the categorization of the unitized pools and did not look through the pool to the underlying securities to report the investments. The misclassification of underling securities reported by the PERF was deemed insignificant to the System's financial statements, and such amounts were not adjusted in the financial statements.

Furthermore, CalPERS' financial statements include inflation asset investments, which are comprised of commodities and treasury inflation-protected securities (TIPS). During our audit, we noted inconsistencies in the way in which inflation asset investments were originally reported in the financial statements. The PERF reported commodities and TIPS as inflation asset investments, whereas the Legislators' Retirement Fund (LRF) and the Judges' Retirement Fund II (JRF II) reported commodities and TIPS as equity and debt securities, respectively. The financial statements were subsequently adjusted to consistently report commodities and TIPS as inflation asset investments for the LRF and JRF II.

We recommend that current accounting practices be evaluated to ensure that investment transactions are consistently and accurately reflected in CalPERS' financial statements in accordance with generally accepted accounting principles.

Management Response:

Fiscal Services Division concurs with the recommendation to ensure that investment transactions are consistently and accurately reflected in CalPERS' financial statements in accordance with generally accepted accounting principles. Trust Accounting I & II staff will work closely together to coordinate the reporting of unitized portfolios to ensure the underlying securities are reported accurately and consistently across program areas. A secondary level of management review will be put in place to provide oversight. Fiscal Services Division will adopt the enhanced approach immediately to support the next fiscal year-end reporting process. This process begins July 2013 and will conclude on October 2013 when the basic financial statements and note disclosures are substantially completed.

Fiscal Year 2012/2013 Status:

During the fiscal year 2012/2013 audit, we did not note any errors in this area. As such, we consider this recommendation to be implemented.

DRAFT

Fiscal Year 2011/2012 Observation #2 – Investment Commitment Disclosures

The Fiscal Services Division utilizes the investment commitment summary worksheet provided by the Investment Office to prepare the investment commitment disclosures in the financial statements. During our audit, we noted the following errors related to the disclosures of investment commitments:

- Corporate governance securities are invested in the form of a partnership structure and are reported as equity securities in the financial statements. We noted one instance in which the original commitment amount was decreased during the fiscal year; however, the adjustment was not reflected in the investment commitment summary worksheet and the draft commitment disclosure was incorrect, which was subsequently revised. In addition, the original corporate governance investment commitment summary worksheet reflected certain commitment amounts in Euros, which should have been converted to U.S. dollars for financial reporting purposes. The amount was subsequently corrected to reflect U.S. dollars for disclosure purposes.

- The System entered into year-to-year contracts with certain real estate partners, in which any commitments not funded during the year must be reevaluated and approved by appropriate CalPERS personnel in order for capital calls to be funded in future years. Due to the nature of these contracts, there are no unfunded commitments for these partners at year-end. The original disclosure of unfunded real estate commitments included expired commitments to partners with year-to-year contracts. The disclosure was subsequently revised to properly exclude these partners.

We recommend the following processes be performed to ensure proper reporting of investment commitment disclosures:

- The Fiscal Services Division and Investment Office should establish a process to ensure that changes in investment commitment amounts are properly captured and disclosed in the financial statements.

- The Fiscal Services Division should establish a process to identify each investment partner that domiciles in a foreign country and verify that the amount is properly reported in U.S. dollars. The process should include inquiries of Investment Office personnel and a comparison of reported amounts to the partners' records.

- The Fiscal Services Division should review the commitment summary worksheets for reasonableness by comparing the changes in total commitment and unfunded commitment amounts for the current and prior years. Unexpected or unusual changes should be investigated and resolved through inquiries of Investment Office personnel and review of the partners' records.

DRAFT

Fiscal Year 2011/2012 Observation #2 – Investment Commitment Disclosures (Continued)

- The Fiscal Services Division should obtain an understanding of the nature and structure of investment contracts to ensure that unfunded commitment disclosures reflect only those commitments for which CalPERS is obligated to fund the remaining commitment amounts.

Management Response:

Fiscal Services Division concurs with the recommendation to ensure proper reporting of investment commitment disclosures. Fiscal Services Division and the Investment Office will work together to implement the suggested recommendations for the next year-end close activities beginning July 1, 2013. The Investment Office will enhance processes by implementing the following steps:

- Gather the necessary data for unfunded liability and capital commitment amounts from Private Equity, Real Assets and Corporate Governance
- Ensure that changes in investment commitment amounts are properly captured and accurately recorded on the commitment summary worksheets
- Ensure all amounts are properly reported in U.S. dollars
- Perform high level reasonableness calculations of amounts compared to prior year numbers
- Prepare an aggregated level schedule that shows the changes from prior period
- Validate the final numbers with the appropriate asset classes and provide appropriate documentation as determined by Fiscal Services Division staff

Fiscal Services Division supports the Investment Office's proposed steps to strengthen and improve the investment commitment disclosures. This also provides Fiscal Services Division the oversight to ensure proper reporting of investment commitment disclosures. Fiscal Services Division will enhance their processes by implementing the following steps:

- Review details of the commitment summary worksheets received from the Investment Office and perform a variance analysis
- Follow up with the Investment Office staff on any unusual or unexpected changes and perform analysis and review

We anticipate the new processes to be implemented and in place for the upcoming fiscal year-end close activities, which will conclude in October 2013.

DRAFT

Fiscal Year 2011/2012 Observation #2 – Investment Commitment Disclosures (Continued)

Fiscal Year 2012/2013 Status:

With the implementation of the Automated Real Estate Information System (AREIS), investment partners are required to input financial information directly into AREIS. The Investment office is responsible for the input of commitment amounts into AREIS using the financial information generated from AREIS, and to provide real estate investment data to the Fiscal Services Division for financial reporting and note disclosure purposes. During the fiscal year 2013 audit, we noted the following errors related to the disclosures of investment commitments:

- One real estate partner incorrectly reported the return of capital of approximately $177 million as an increase in the unfunded commitment balance in AREIS. CalPERS does not have an obligation to fund the return of capital amount in the future, and, as such, this return of capital balance was subsequently excluded from the disclosures in the System's financial statements.

- Two infrastructure partners incorrectly reported discretionary commitment amounts in the unfunded commitment balances. CalPERS is not required to fund the discretionary commitment amounts. As such, these amounts were subsequently excluded from the disclosures in the System's financial statements.

Fiscal Year 2012/2013 Management Response:

The Investment Office concurs with the recommendation to ensure proper reporting of investment commitment disclosures and will work to implement new control functions for the next year-end close activities beginning July 1, 2014. The Investment Office will enhance processes by implementing the following steps:

- Implement a new enhancement in AREIS to reduce the possibility of a partner incorrectly recording non recallable distributions that impact the unfunded commitment in AREIS as noted above.
- Investment office staff will adjust the commitment amounts in AREIS to remove any discretionary infrastructure commitments and track outside of the ARIES unfunded commitment reporting.

We anticipate the new control processes to be implemented and in place for the upcoming fiscal year-end close activities, which will conclude in October 2014.

DRAFT

Fiscal Year 2011/2012 Observation #3 – Internal Controls Over Benefit Processing

CalPERS implemented the Pension System Resumption (PSR) Project or my|CalPERS system during fiscal year 2011/2012. In testing the Public Employees' Retirement Fund (PERF) benefit payments originating from my|CalPERS, we noted two instances of incorrect pensionable salaries, one instance of incorrect service credit purchases, and one instance of an incorrect retirement factor. These errors resulted in incorrect retirement benefit amounts, which were subsequently corrected. The primary cause of the errors was the result of the implementation of my|CalPERS.

We recommend the responsible department strengthen internal controls over benefit processing and reevaluate current policies and procedures to ensure accurate data is used in calculating retirees' benefit amounts.

Management Response:

Customer Services and Support concurs with the findings. During the first year of my|CalPERS implementation, incorrect data elements were periodically identified through testing and manual validations and were subsequently corrected. Upon major system enhancements, testing and validation continues to occur to verify consistency and accuracy. Policies and procedures on testing and validation will continue to occur and progress will be evaluated by June 30, 2013.

Fiscal Year 2012/2013 Status:

During the fiscal year 2012/2013 audit, we did not note any errors in this area. As such, we consider this recommendation to be implemented.

Fiscal Year 2011/2012 Observation #4 – Self-Funded Healthcare Enrollment Reconciliation

We previously reported as observation #8 in fiscal year 2006/2007 that the reconciliation of enrollment records between the third-party administrator and CalPERS' records for the Healthcare Fund (HCF) was not performed timely. Blue Cross is the third-party administrator of the self-funded PERS Care, PERS Choice, and PERS Select health plans. Blue Cross reconciles, on a monthly basis, enrollment records and the related premiums received from the State of California (State). During our testing of premium revenues for the HCF, we noted the monthly enrollment reconciliations were not completed in a timely manner. As of October 2012, the most recent reconciliation was for the month of October 2011.

We recommend that management establish procedures to ensure Blue Cross enrollment records are reconciled to CalPERS records in a timely manner, and that any discrepancies are investigated and resolved prior to the next billing cycle or within a reasonable timeframe.

DRAFT

Fiscal Year 2011/2012 Observation #4 – Self-Funded Healthcare Enrollment Reconciliation (Continued)

Management Response:

As a result of CalPERS Enterprise-wide systems automation project implemented in September 2011 (my|CalPERS), existing Premiums Reconciliation file formats and file transfer protocols changed. As a result, Anthem Blue Cross could not generate the Premiums Reconciliation report for more than one year. CalPERS and Anthem Blue Cross agreed to halt the my|CalPERS Premiums Reconciliation file transfer format and resume using the my|CalPERS enrollment file. CalPERS and Anthem Blue Cross have agreed the most prudent approach to corrective action is to perform an on-going reconciliation with the enrollment file, rather than use the Premiums Reconciliation file until the my|CalPERS Premiums Reconciliation interface is functional. Anthem Blue Cross will utilize a complete enrollment file and will provide CalPERS an enrollment discrepancy report. CalPERS and Anthem Blue Cross will then jointly work to address the enrollment discrepancies. CalPERS will meet with Anthem Blue Cross to work through the details of the reconciliation process. In addition, regular touch-point meetings with Anthem Blue Cross will continue to ensure this process continues to move forward. CalPERS has also assigned an individual to document this procedure.

It's important to note that the functionality in my|CalPERS has been designed to minimize enrollment discrepancies. For example, the functionality in my|CalPERS supports the cancellation for non-payment (i.e. no health deduction taken from pay warrant) for active employees. This reduces the likelihood of an individual obtaining services and not paying a premium.

Customer Services and Support Division concurs with the recommendation and will work closely with Anthem Blue Cross to develop the procedures by April 30, 2013 and will implement the reconciliation process by July 31, 2013.

Fiscal Year 2012/2013 Status:

During fiscal year 2012/2013, enrollment reconciliation procedures were established; however, we noted the procedures did not specify the required timeframe to complete the monthly enrollment reconciliation. We recommend that the timeline to complete the monthly reconciliation be incorporated in the procedures.

Fiscal Year 2012/2013 Management Response:

Customer Account Services Division (CASD) and Anthem Blue Cross (Anthem) have implemented a full-file reconciliation process that takes place on a monthly basis. CASD and Anthem will continue reconciliation processing on the monthly timeline, and procedures will be updated to reflect the changes to the business process. The timelines of the enrollment reconciliation process will be implemented August 2014.

DRAFT

Fiscal Year 2011/2012 Observation #5 – Access to Programs and Data

IT General Controls should ensure that data is appropriately secured so as to ensure the accuracy, integrity and completeness of the data. While CalPERS Information Security Office (ISOF) has implemented the Guardium SQL device to monitor database activity, independent testing of the device has not yet been performed. Independent testing can help ensure that the device is identifying all possible unauthorized database layer changes.

The ISOF should have periodic independent testing performed of the Guardium SQL device to ensure that it is detecting and reporting all suspicious database layer activity.

Management Response:

The Information Security Office (ISOF) concurs with this finding. The ISOF will have periodic independent testing of the Guardium SQL device performed to supplement our internal testing. This independent testing will provide additional assurance that the Guardium device is detecting and reporting all suspicious database layer activity. The first test will be conducted August 31, 2013 because a Guardium upgrade is planned for the current fiscal year. ISOF will retain documentation of the results of the testing. The Information Security Office expects to complete this item by August 31, 2013.

Fiscal Year 2012/2013 Status:

This recommendation has been implemented. The Office of Audit Services conducted independent verification testing in August 2013 with plans to repeat the testing quarterly. The testing validated the accuracy of the Guardium reporting function. While the first test was limited in scope, it confirmed that the Guardium device is capturing database layer activities by Database Administrators.

Fiscal Year 2010/2011 Observation # 2 - Reconciliation of Benefit Payments

In fiscal year 2010/2011, benefit payment reconciliations were not performed in a timely manner. The Retirement Information Benefit System (RIBS) is used to calculate retiree pension benefits and release warrants for payment. The Fiscal Services Division performs the benefit payment reconciliation by comparing the activity reflected in RIBS to the activity reported in the general ledger. The reconciliation is generally performed on a semi-annual basis; however, for fiscal year 2010/2011 staff performed only one reconciliation, which was completed more than three months after the fiscal year-end.

We recommend that the Fiscal Services Division perform periodic and timely reconciliations of benefit payment activity to ensure that amounts recorded in the general ledger are complete and accurate.

DRAFT

Fiscal Year 2010/2011 Observation # 2 - Reconciliation of Benefit Payments (Continued)

Management Response:

The Fiscal Services Division concurs with the observation and recommendation. With the implementation of my|CalPERS, new processes are being developed to timely ensure benefit payment activity is accurately recorded in the general ledger. Fiscal Services Division expects to complete this item by June 2012.

Preliminary Implementation Plan:

By June 30, 2012, Fiscal Services Division will take the following steps:

Prior to the implementation of my|CalPERS in September 2011:

- Benefit payments were reconciled between the Retirement Information Benefit System (RIBS-legacy system) and Comprehensive Financial Report (CAFR) expenses.

- This process was performed on a semi-annual cycle as CAFR expenses through December 31st and June 30th were taken from the semi-annual flux analyses (Semi-annual analytical review), which were produced in April 2011 and September 2011, respectively.

- The timing of flux analyses was one of the reasons why reconciliations were never completed within 30 days of month-end.

The Fiscal Services Division will now:

1. Prepare the last legacy RIBS to PeopleSoft reconciliation. Continue the process of preparing the 12/31/2011 reconciliation and will complete it within 30 days of receiving the Flux analysis in April 2012. This will be a combination of converted legacy data and new my|CalPERS.

2. Validate that my|CalPERS transactions agree to amounts posted to PeopleSoft. This is currently done on a daily basis at the individual account level rather than the CAFR rollup.

3. Reconcile each of the individual accounts that make up the CAFR total on a monthly basis. This will ensure reconciliations are completed timely.

4. Provide the auditors a schedule that lists the individual accounts, which will tie to the CAFR amount.

5. Provide cross-training of additional staff so that any future staff interruptions will not hinder our ability to perform the reconciliation in a timely manner.

DRAFT

Fiscal Year 2010/2011 Observation # 2 - Reconciliation of Benefit Payments (Continued)

Fiscal Year 2011/2012 Status:

During the fiscal year 2011/2012 audit, there was only one reconciliation performed for benefit payments between the RIBS and the general ledger system for the periods of July through September 2011. The reconciliation was completed in May 2012. Also, in September 2011, CalPERS implemented the new Pension System Resumption (my|CalPERS) system, and we noted benefit payment reconciliations were not completed in a timely manner due to the introduction of the new system's functionalities and challenges in generating the appropriate reports from my|CalPERS to perform the reconciliations. Fiscal Services Division should continue to ascertain that timely benefit payment reconciliations are performed to ensure complete and accurate financial reporting.

Fiscal Year 2011/2012 Management Response:

The Fiscal Services Division concurs with the recommendation to perform periodic and timely reconciliations of benefit payment activity to ensure that amounts recorded in the general ledger (GL) are complete and accurate. The GL Account Receivable Metric (GLARM) Reports needed to complete the benefit payment reconciliations were not available at the time of required reconciliation due to delays in the implementation of the myCal|PERS system. Subsequently, we received the necessary GLARM Report, and implemented the recommendation in June 2012 as originally indicated. The GLARM report now provides information necessary to reconcile the financial activity generated in my|CalPERS and sent to PeopleSoft. We are now able to perform timely benefit payment reconciliations to ensure the amounts recorded in the general ledger are complete and accurate and will continue to do so in the future.

Fiscal Year 2012/2013 Status:

During the fiscal year 2012/2013 audit, we noted the Fiscal Services Division performed timely benefit payment reconciliations. As such, we consider this recommendation to be implemented.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals

Properties held in separate account real estate partnerships are valued based on third-party appraisals directed by the System. Appraised values are adjusted by the general partner to reflect changes in fair value between the appraisal date and the end of the System's financial reporting period. The System's real estate Performance Monitoring Unit (PMU) is responsible for ensuring appraised property values are properly recorded by the partnerships in accordance with the System's Investment Policy for Real Estate Accounting. During our testing of real estate partnership investments, we noted the following:

- The PMU faces significant challenges in performing the task of verifying that appraised values are being properly reflected in the partnerships' financial statements in a timely manner as there were approximately 1,600 individual properties appraised in fiscal year 2008/2009 and only one staff was assigned to perform this function.

DRAFT

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

- Certain general partners report to the System at the aggregate or fund level rather than the individual property level. In some instances, it was difficult to verify that the appraised values were reflected by the partnerships as the property-level financial information is not provided by all general partners.

- Appraisals are completed throughout the fiscal year; however, there is no process in place to evaluate the changes in fair value from the appraisal date to the System's fiscal year-end.

The System should enhance the current processes by employing the following recommendations:

1. Assign the appropriate number of personnel to verify that appraised property values are recorded by the partnerships.

2. Require separate account general partners to provide financial information at the underlying property level to facilitate the appraisal verification process.

3. For separate account real estate partnerships that were not appraised as of the System's fiscal year-end, review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

Management Response:

The Investment Office (INVO) concurs with the MGO recommendations and will enhance the following current processes by June 30, 2012:

1. At this point, INVO has not requested additional positions to verify the appraised property values recorded by the partnerships in their quarterly financial statements. INVO will examine its current staffing to determine if positions could be redirected from other INVO functions to perform this role.

2. The new Automated Real Estate Information System (AREIS) will provide the structure for reporting the financial information at the underlying property level. The System is currently in its final stage of implementation. Real Estate general partners should have the ability to report at the property level starting with the 2010-11 Fiscal Year.

3. The INVO, Operations, Performance and Technology Division has recently instituted a new process where they now value CalPERS interests (required by the Appraisal of CalPERS Interests Policy) no more than five (5) months prior to June 30 of every year. This allows for no appraisal value of CalPERS interests to be more than 5 months old when provided as part of the year-end financials.

DRAFT

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

Fiscal Year 2009/2010 Status:

1. Although one staff continued to perform the function of verifying that appraised values are properly reflected in the partnerships' financial statements, the number of properties verified at the time of the audit has significantly increased compared to fiscal year 2008/2009. CalPERS personnel discussed, with the respective partners, the reasons for variances between appraised values and the partnerships' financial statements, however, we noted CalPERS currently does not have a formal documented policy for following up with the partners in addressing and resolving variances. We recommend that INVO enhance this process by establishing a threshold for investigating variances between the appraisals and partnerships' financial statements. Any variances meeting the threshold should be investigated, resolved and documented in the reconciliation.

2. In fiscal year 2009/2010, AREIS was not fully implemented and this recommendation is anticipated to be implemented in fiscal year 2010-11. As AREIS is fully implemented in the future, CalPERS should enhance the following processes:

   a. Ensure real estate partners provide financial information at the underlying property level for all partnerships in which CalPERS holds a majority effective ownership interest.

   b. Establish a process to specify the responsible party who will be inputting CalPERS' effective ownership percentage within AREIS.

   c. Because INVO personnel utilize CalPERS' effective ownership percentage from AREIS in verifying that the appraised values are properly reflected in the partnerships' financial statements; CalPERS' effective ownership percentage should be validated by appropriate personnel who possess sufficient knowledge of the partnership agreement and structure. Furthermore, CalPERS' effective ownership percentage should be periodically reviewed and updated by appropriate personnel.

3. For properties that were not appraised as of CalPERS' June 30th fiscal year-end, INVO should continue to evaluate whether significant changes in fair value between the most recent appraisal and the partners' June 30th financial statements are reasonable given known facts and conditions such as the real estate industry and market conditions. CalPERS should also develop a formal documented process including a tolerance threshold for evaluating changes in fair value. This process should be performed for real estate partnerships in which CalPERS holds a majority effective ownership interest.

DRAFT

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

Fiscal Year 2009/2010 Management Response:

INVO concurs with the recommendations and will enhance the following processes with target completion date on June 30, 2012:

1. INVO - Operations, Performance and Technology Division (OPTD) - Performance Monitoring Unit (PMU) shall expand the current documented procedures for the reconciliation process of appraised values to include a threshold for investigating variances between the appraisals and partnerships financial statements. The process will provide detailed guidelines to determine if the variance should be investigated, resolved and documented.

2. INVO will enhance the following processes:

   a) AREIS provides the structure for reporting financial information at the underlying property level. Although the Real Estate general partners have the ability to report at the property level, not all partners are contractually required to do so. INVO will include provisions in all new majority-interest partnerships formed, to include a requirement to provide property level financial statements when it is in the best interest of the fund. In addition, INVO will work with its current majority-interest partnerships to request that they provide property level financial statements when it is in the best interest of the fund.

   b) INVO shall establish a process to specify the responsible party for providing CalPERS effective ownership percentage within AREIS.

   c) INVO shall establish a process to ensure the CalPERS effective ownership percentage is validated by appropriate personnel and is periodically reviewed and updated by appropriate personnel.

3. INVO-OPTD-PMU shall develop a formal documented process to review the fair values contained in the financial statements on fiscal year end June 30th. The process shall include a risk tolerance threshold for evaluating any change in fair value since the last appraisal. The process should be performed for real estate partnerships in which CalPERS holds a majority effective ownership interest.

Fiscal Year 2010/2011 Status:

1. This recommendation has been implemented.

DRAFT

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

Fiscal Year 2010/2011 Status (Continued):

2. The following is the current year status for the recommended processes:
   a. Financial information is provided by all Real Estate Investment Partners directly into the AREIS system. For Partnerships in which CalPERS holds a majority effective ownership interest, the financial information provided includes property level market valuations. Typically, property level valuations are contained within the statement of "Portfolio Market and Cost Values" or the "Portfolio Market and Book Values". In a few instances, the property level valuations are provided in other areas of financial information of the Quarterly Management Report (QMR). The property level valuation information provided by partners provides the necessary financial information to facilitate the appraisal reconciliation process. This recommendation is considered implemented.

   b. When a Real Estate Partnership is created in the AREIS system, the Real Estate Unit ensures CalPERS' Partnership ownership percentage is correctly entered into AREIS. If CalPERS' Partnership ownership percentage changes, the Portfolio Analytics, Research and Operations (PARO) Unit will work with the appropriate Portfolio Manager in CalPERS Real Estate Unit (REU) to establish the correct ownership percentage and will then input the information into AREIS. The PARO Unit will draft formal written processes.

   c. The PARO Unit will input the information into AREIS and will work with the appropriate Portfolio Manager in CalPERS REU to verify the effective ownership percentage.

3. The Performance Monitoring Unit will develop a process for reviewing partnerships' June 30 financial information to ensure significant changes in fair value are properly reported.

Fiscal Year 2011/2012 Status:

During fiscal year 2011/2012, all recommendations have been implemented with the exception of the development of a formal process for reviewing partnerships' June 30 financial information to ensure significant changes in fair value are properly reported. The formal process will be completed in fiscal year 2012/2013.

Fiscal Year 2012/2013 Status:

This recommendation has been implemented.

DRAFT