Summary of State Controller Office's Review Report on Pension Controls and Mechanisms
Current Update as of September 30, 2014

Audit (Report Issue Date): Pension Controls and Mechanisms (9/09/14)
Finding: CalPERS lacks sufficient oversight of reporting entities

Recommendation 1: Increase the frequency with which its reporting entities are reviewed by increasing the number of audit staff. With limited resources, CalPERS should enhance pension spiking monitoring through enhanced technology-based analysis.

Management's Original Response: The CalPERS Office of Audit Services (OFAS) presented an agenda item to the CalPERS Board of Administration (Board) in August 2012 that addressed the Public Agency Review Program Expansion Alternatives. In reviewing the expansion alternatives, the Board agreed that additional resources should be provided to increase the number of reviews performed. For the fiscal year ending June 30, 2014, the OFAS reviewed 99 public agencies, consisting of 48 final reports, 34 pending agency responses, and 17 more reports that are significantly complete and going through our internal quality review to ensure accuracy. We will continue to evaluate and determine if we need to expand our review efforts. CalPERS has also made a commitment to revisit whether resources, in addition to those already approved, are warranted once staffing has fully assimilated and stabilized.

Recommendation 2: Continue to use a risk-based analysis and other evidence-based criteria to identify which reporting entities to review. To aid in its annual workplan, CalPERS should include the "high-pay compensation in excess of $245,000" attribute in its annual risk assessment. This attribute can be given a larger weighting in the risk analysis to satisfy the CalPERS Board's concerns. This analysis should be used to determine the number of entities that should be reviewed each year as well as the resources needed to properly provide program oversight.

Management's Original Response: CalPERS believes that one of the reasons the SCO's report "did not identify pension spiking" among the agencies it reviewed is due, in part, to CalPERS' effective and comprehensive approach to employer education and compliance activities.

When payroll is submitted we apply additional audits and edits as an initial layer of review. In addition, CalPERS performs reviews of employer payroll data, including active and inactive employees.

The need for these reviews might be identified by CalPERS staff during normal monitoring activities, system reviews or impromptu reviews. Reviews might also be identified by members of the public who submit tips or by members of the media.

OFAS historically utilizes a risk-based approach to identify and prioritize which reporting entities

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to review and will continue to use this and other effective approaches. OFAS has, and continues to use, high compensation (in excess of $245,000) as one of several risk factors in the risk assessment. Our risk assessment is a dynamic and fluid process that is refined each year as the environment and conditions change. Consequently, risk factors and corresponding weights of these factors are subject to change with each annual assessment completed. That said, it is important to emphasize that the scope of the SCO's review coincided with several high-profile local government pension related cases such as the City of Bell.

During fiscal years 2013-14 and 2014-15, OFAS selected a combination of high-risk, high-paid, medium-risk, and low-risk agencies as well as agencies identified through tips from the general public. Selection of agencies during the current year involves consideration of agencies identified as high-risk that have never been reviewed, and selection of both medium- and low-risk agencies. CalPERS is also developing a business intelligence program using technology and data analytics to identify membership and payroll reporting anomalies across its membership.

Recommendation 3: Perform an analysis to determine the additional types of resources needed in order to provide more effective and adequate oversight of the entities reporting to CalPERS for active employees.

Management's Original Response: CalPERS believes that one of the reasons the SCO's report "did not identify pension spiking" among the agencies it reviewed is due, at least in part, to CalPERS' effective and comprehensive approach to employer education and compliance activities. CalPERS engages in prevention activities by providing hundreds of classes annually to its employer community detailing information on payroll submission, including statutory and regulatory requirements and prohibitions. Further, we provide individualized education when requested or as needs are identified by CalPERS staff. When payroll is submitted we apply additional audits and edits as an initial layer of review. In addition, CalPERS performs reviews of employer payroll data, including active and inactive employees. The need for these reviews might be identified by CalPERS staff during regular employee or employer reviews, system reviews or impromptu reviews of all data. Reviews might also be identified by members of the public who submit tips, or by members of the media.

While adequate resources are a key part of effective monitoring, it is premature to assume that additional resources are the most effective route to dissuade pension spiking. CalPERS is committed to continuously monitoring our resources to meet our fiduciary responsibilities. To that end, CalPERS will develop and evaluate effective and efficient options for consideration, including the review of the level of payroll oversight at or near submission by entities. These options will include a variety of alternatives, with anticipated costs and potential outcomes. Options will evaluate industry leading practices and innovative approaches, utilizing technology assistance such as Business Intelligence and data reports. It will also take into account any adjustments as a result of changes incorporated as related to the CalPERS response to Recommendation 1.

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Recommendation 4: Require procedures to review active employees' pay amounts for material increases in compensation and special compensation amounts.

Management's Original Response: CalPERS already has procedures in place to review active employees' pay amounts for increases as well as inappropriate reporting, in general. Listed in CalPERS' response to Recommendation 3 are scenarios in which oversight is performed on active employee payroll records. For example, as part of the general maintenance performed on employer records, the Compensation Review Unit has several processes in place that assist in the oversight of reporting entities including active members. The Compensation Review Unit conducts thorough case reviews to verify that the payroll reported in our system is compliant with the Public Employees' Retirement Law (PERL). This includes reviewing documents such as payroll records, memorandums of understanding, written labor policies or agreements, publicly available pay schedules, and Personnel Action Forms. In those instances where reported payroll does not appear to comply with the PERL, appropriate follow-up action is undertaken by the Compensation Review Unit.

The OFAS continues to identify in its risk assessment, agencies that have active employees with high pay and special compensation amounts. Those agencies that have highly-paid employees and high levels of special compensation are provided a risk factor and weight. These two factors are included with other factors to identify and prioritize those agencies to review each year. Further, OFAS' review program includes procedures that test for salary increases, correct reporting of employee pay rates, and correct reporting of employee compensation and earnings.

Recommendation 5: Review and analyze the Public Employees' Retirement Law for any necessary clarifications or enhancements to allow CalPERS to provide better oversight of its member entities.

Management's Original Response: Each year, CalPERS sponsors an omnibus bill to make minor non-controversial changes to the PERL, and may sponsor additional legislation to make more substantial changes. Since 2008, CalPERS has sponsored 19 bills, including legislation in 2011 that impacted the definition of pay rate (AB 1028, Ch. 440, St. 2011) and added cost recovery mechanisms for auditing contracting agencies (AB 782, Ch. 107, St. 2011). In addition, CalPERS establishes regulations to implement these and other changes to the PERL, including regulations that require contracting agencies to make their pay schedules publicly available (Title 2, Sec. 570.5, operative 7/11/2011). CalPERS will continue its existing process to review and analyze the PERL for any necessary clarifications or enhancements to allow CalPERS to improve oversight of its member entities. In addition, CalPERS will continue to be available to provide assistance to the Legislature and other state agencies that may pursue changes to the laws that govern public pension systems.

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Recommendation 6: Request additional analytical staff and/or auditors for the Compensation Review Unit to aid in the review of potential spiking by active employees.

Management's Original Response: As identified in CalPERS' response to Recommendation 3, it is premature to assume that additional resources are the most effective route to dissuade pension spiking. CalPERS is committed to continual monitoring of our resources to adhere to our fiduciary responsibilities. To that end, CalPERS will develop and evaluate effective and efficient alternatives for consideration to review the level of oversight of payroll at or near the time of submission by entities reporting to CalPERS. These alternatives will include a variety of alternatives, with anticipated costs and potential outcomes, evaluating industry leading practices and innovative approaches utilizing technology assistance, such as Business Intelligence and attribute data reports, where possible. It will also take into account any adjustments as a result of changes incorporated from CalPERS' response to Recommendation 1.

These alternatives will include all required resources to ensure that we continue to provide effective and efficient oversight of reporting entities. Staff will move the recommendation into the next annual planning cycle as appropriate.

Observation: Statute Authorized publicly-funded enhancements of pension benefits

Observation Recommendation: The California Legislature has amended the existing Government Code section 20692, to terminate this optional benefit. We recommend that, for future optional benefits, CalPERS and contracting agencies thoroughly analyze any pension enhancement programs prior to enactment, to determine the true cost of the program. This information should be made public so that there can be an informative dialogue for discussion on the merits of the program.

Management's Original Response: The Legislature and the Governor are responsible for passing and enacting any optional benefits that become part of the Public Employees' Retirement Law (PERL). As part of that legislative process, CalPERS is already required by Government Code section 20236 to provide a cost analysis on any legislative bill that changes the benefit structure of this system. As part of the legislative process, and consistent with the Observation recommendation, CalPERS routinely provides cost information to the legislature that is used as part of the public policy debate and fiscal committee analysis. This information includes the impact to the General Fund for State- and school-related benefit changes. For benefit changes related to public agencies, CalPERS also provides a range of potential cost impacts.

For further clarification and for those who may be unfamiliar with the Employer Paid Member Contributions (EPMC), it is an employment practice routinely utilized by, and included in the laws applicable to, public retirement systems in California. CalPERS administers the EPMC provision of the PERL and has no discretion when an entity has complied with the statutory requirements for EPMC. In addition, the numbers of employers listed in the SCO Review report

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as utilizing EPMC are higher than the numbers so identified in the CalPERS database. We will continue to work with the SCO to reconcile the differences. For these reasons, CalPERS staff believes that EPMC is outside the stated scope of the audit and the observation section in this report and all other references to EPMC would be better addressed in a standalone report on that topic.