

CalPERS Board Education Program

Internal Controls, Financial Reporting, and Audits

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About Me

- Professor of Accounting at Graduate School of Management
- M.S. and Ph.D. in accounting
- CPA for over 20 years

Outline

- Setting the Stage: The Risk Management Process
- Internal Controls
- Financial Reporting Process and Outputs
- Auditing Process and Outputs



Setting the Stage: The Risk Management Process

Effective Risk Management Oversight with the Three Lines of Defense

Integrated Assurance Model: The Three Lines of Defense



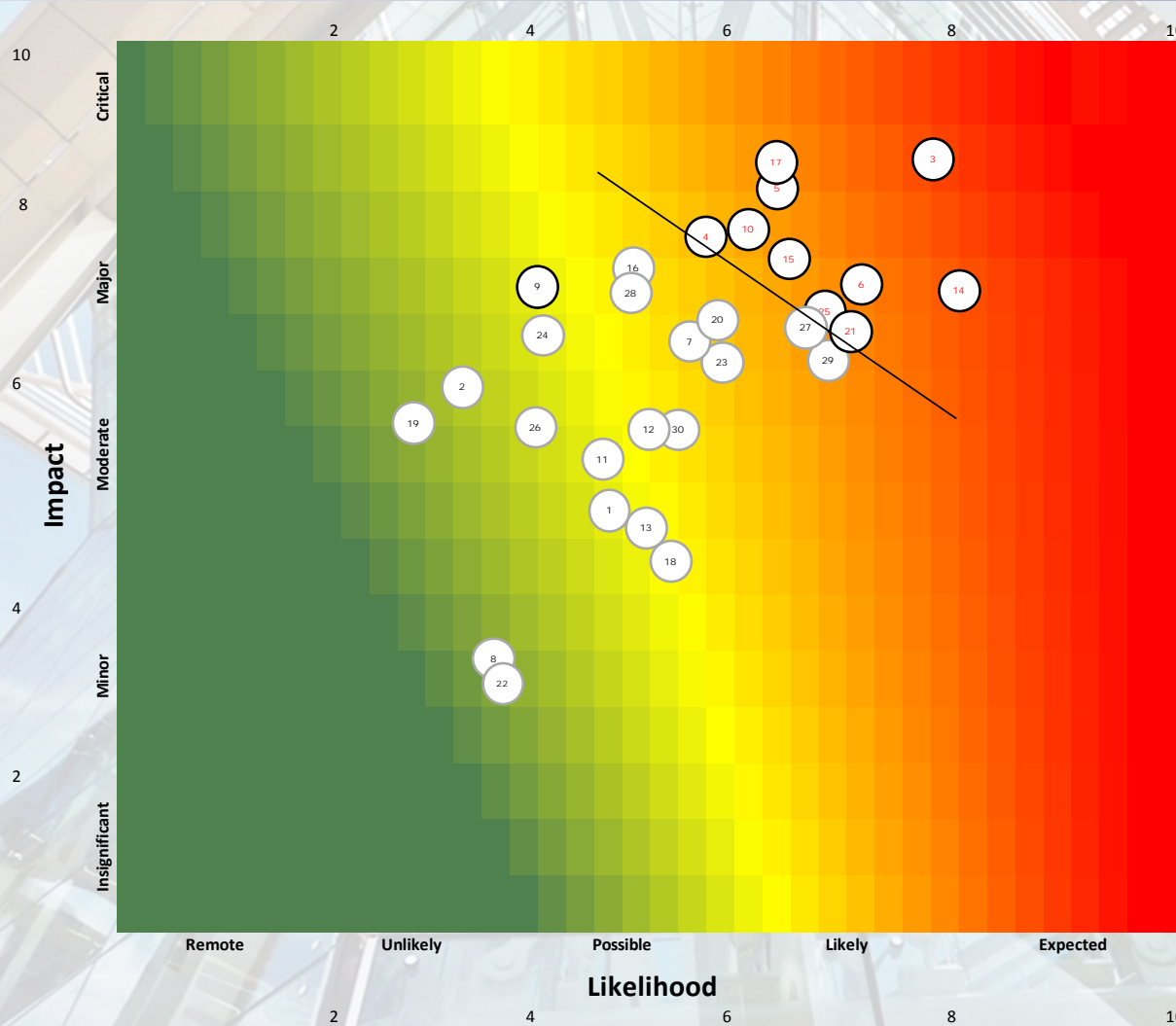
Setting the Stage: Board Oversight of the Risk Management Process

- Boards are responsible for overseeing the processes and controls that reduce residual risk to acceptable levels
- Discussion: What is residual risk?

Risk Management

- Risk can be thought of as the product of two dimensions:
 - The probability of a loss (likelihood)
 - The cost of a loss
- A loss can be thought of as reductions in assets or increases in liabilities
- Not all losses are financial
- Discussion: Discuss some important risks for CalPERS
 - What is the probability?
 - What is the potential cost (financial and non-financial)?

CalPERS Risk Heat Map



Top 10 risks highlighted in red.

- Risk Domains**
- Governance / Leadership
 - Strategic Planning and Implementation
 - Pension Funding (Asset Liability Management)
 - Asset Allocation
 - Participating Employer Financial Hardship / Insolvency
 - Human Resources Management
 - Health Care Costs
 - Long Term Care Program
 - Legislative/Regulatory
 - Stakeholder Perception
 - Business Planning
 - Organization
 - Procurement and Contract Management
 - Business Continuity Management
 - Physical Security Controls
 - Technology / Systems Management
 - Information Security
 - Customer Service
 - Health Plan Management
 - Data Integrity & Management
 - Financial Controls and Systems
 - Financial Planning
 - Financial Reporting
 - Investment Risk Management
 - Investment Controls and Systems
 - Actuarial Policies/Practices
 - Laws, Rules and Regulations
 - Fraud Detection and Prevention
 - Policy and Procedures
 - Ethical Conduct and Standards

- Top risk domains
- Non Top risk domains
- Top risk domains above line

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Risk Management (continued)

- Management is responsible for designing, implementing, and testing those systems
- Part of a Board's responsibility is to come to an understanding of whether Management's risk processes and controls are satisfactory and sufficient
- Risk of Asset-Liability management
 - Probability?
 - Amount?
 - What might some Risk Management controls be?



Internal Controls

Internal Controls

- System designed to provide reasonable assurance that assets are properly safeguarded, transactions are properly executed, and financial information is reliable
- Cannot, in practical terms, provide absolute assurance over every asset or transaction
 - Board plays key role in setting acceptable level of risk
- Risks, and choices over acceptable levels of residual risk, drives the choice of the Internal Controls used
 - Internal Controls must be subjected to a cost-benefit analysis

Internal Controls and the Three Lines of Defense

1: Operational

- Day to day management and staff operations
- Everyone plays a role, everyone owns a piece of internal control, not just the auditors

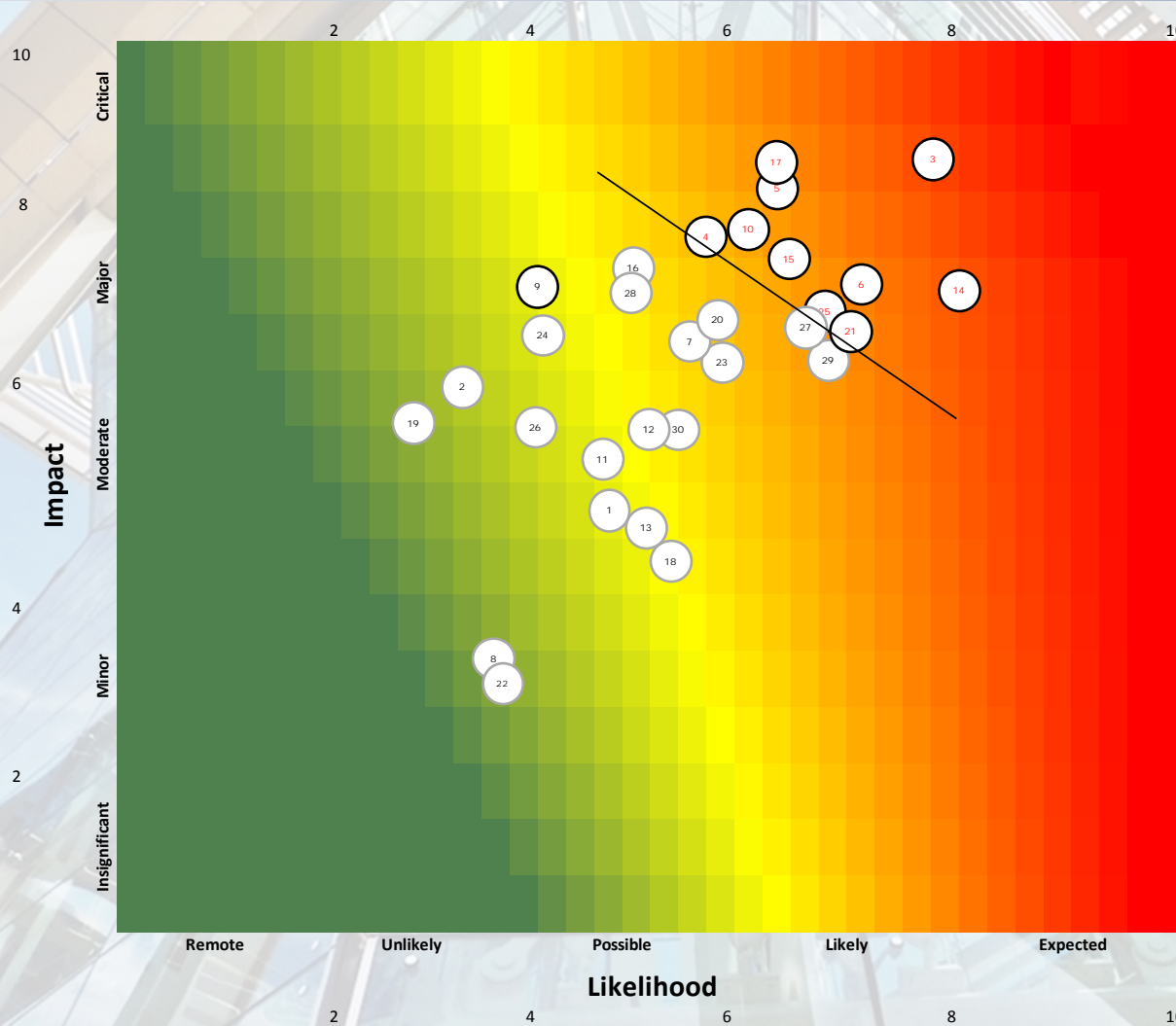
2: Risk Management and Compliance

- Internal risk management structure and efforts (enterprise system)
- Establish Owner and Oversight

3: Audit and Assurance

- Internal and external validation of risk management processes

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June 2015

Internal Control Prioritization

- Risk Heat Maps are useful for allocating Internal Control assets
 - Shows where focus should be
- The benefits of mitigating a risk through Internal Controls rises as you move from Green to Red (lower left to upper right)
- Discussion: Should an internal control system be designed to mitigate lower risks (i.e., those in the “green” region?)

Internal Control Structure, Ownership, and Oversight

- Current best practice is a system of Internal Control that is integrated across operational areas
- Not enough just to have an Internal Control system in place, three other features are just as critical:
 - Who owns the specific internal control function?
 - Who monitors/tests the specific internal control function?
 - Who oversees the Internal Control process at the highest level?
 - Responsibility to ensure that owners exist, and are monitored by proper persons

Internal Control Discussion

- What is the risk management design at CalPERS?
- Risk of Asset-Liability Management
 - Ownership?
 - Oversight?
- Risk of Employer Financial Hardship
 - Ownership?
 - Oversight?
- Risk of Information Security
 - Ownership?
 - Oversight?

CalPERS Enterprise Risk Management Dashboard

Risk Category	Risk Domain	Risk Ranking				Previous Trend	Projected Trend	Owner	Oversight	
		Oct-13	May-14	Oct-14	May-15					
3	Strategic	Pension Funding (Asset Liability Management)							Chief Investment Officer Chief Actuary Chief Financial Officer	Investment Committee Finance and Administration Committee
4	Strategic	Asset Allocation	*						Chief Investment Officer Chief Operating Investment Officer	Investment Committee
5	Strategic	Participating Employer Financial Hardship/Insolvency							Chief Financial Officer	Finance and Administration Committee
14	Operational	Business Continuity Management							Chief Financial Officer	Risk and Audit Committee
17	Operational	Information Security							DEO, Operations & Technology	Finance and Administration Committee
6	Strategic	Human Resources Management							DEO, Operations & Technology	Performance, Compensation & Talent Management Committee

* Not identified as a risk domain during this reporting period

Residual Risk - Considering risk responses and the remaining risk exposure.	
	Minimal
	Moderate
	Elevated
	High

Trend - Considering risk management plans and environmental factors, the residual risk trend over the next 6 months.	
	Decrease
	Remain Constant
	Increase

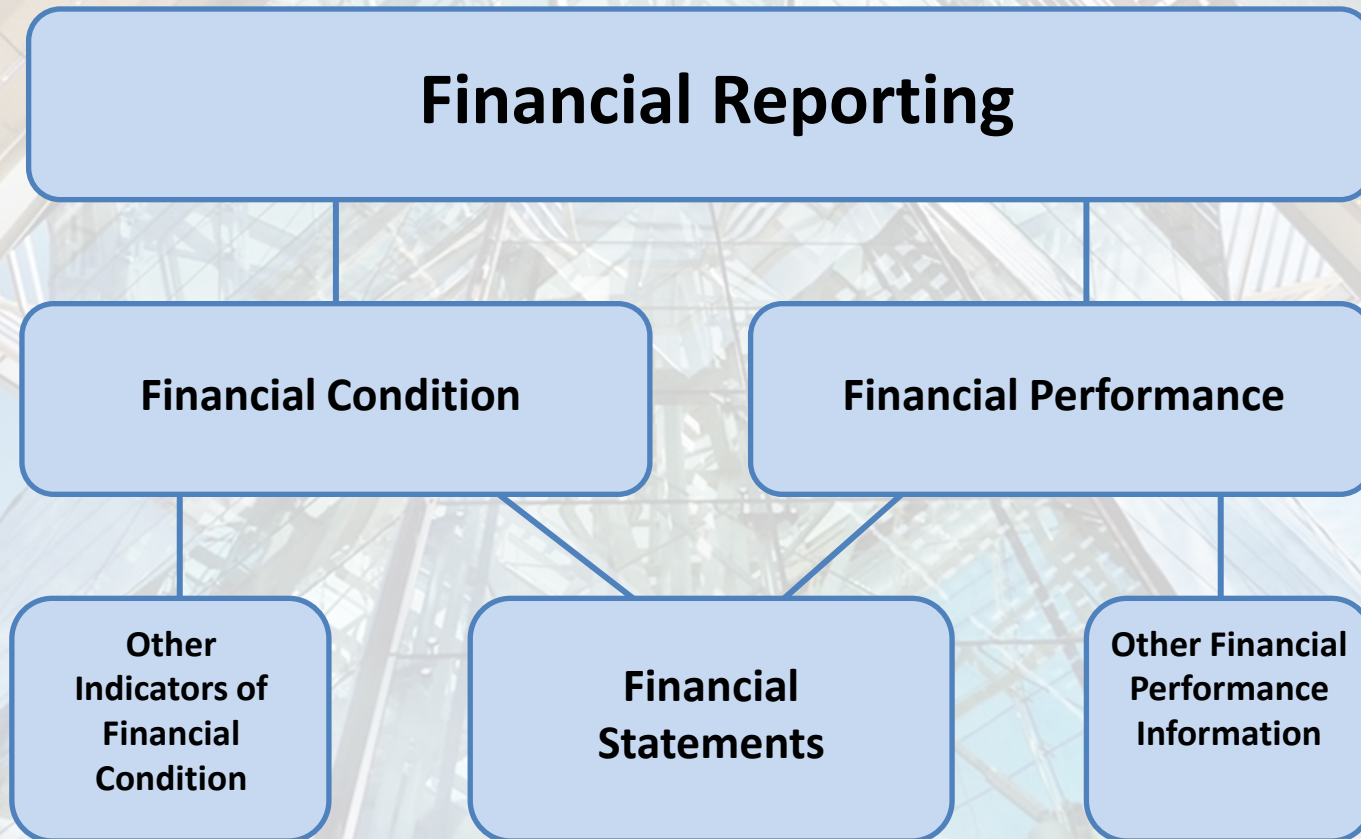
Board Oversight of Internal Controls

- Have we identified a reasonably comprehensive set of risks facing the organization?
- Have we prioritized those risks according to potential loss?
- Have we put in place an internal control system that mitigates those risks, considering the cost/benefits of doing so?
- How/when does Audit Services (or others) test the functionality of each Internal Control system?
- How/when does the Board receive reports on Internal Controls?



Financial Reporting

The Importance of Financial Reporting



Financial Reporting Process and Related Outputs

- Aggregating and accumulating thousands upon thousands of various transactions
 - Truly a wonderment
- Accuracy of the data is completely contingent on the systems used to collect and report that data
- Highlights the risk associated with financial reporting systems, and the importance of a robust internal control system over Financial Reporting

Finance and Administration Committee

- Committee has responsibility for receiving and at times approving various financial reports
 - Annual Financial Statements as audited by external auditors
- Committee also owns a variety of important risks, each of which involves some financial reporting from the financial reporting system:
 - Information Security
 - Employer Financial Hardship
 - Asset/Liability Management

Board Responsibility

- Board has authority to oversee the financial reporting process, as well as the outputs of that process (financial reports)
- Board exercises that oversight by:
 - Requiring periodic reports on the functioning of the reporting system (internal audits)
 - Reviewing the outputs (financial reports)
 - Overseeing external validation of those reports (external audits)

Internal Control Over Financial Reporting

- Commonly not identified as a top risk category in any organization (see Heat Map)
- Why is there such an extensive system of internal control (and as we will see later auditing) over financial reporting?
- Because reliable financial data is critical for the State of California, Employers and Members
- And....
- Several Legal requirements for a robust internal control system over financial reporting
 - FCPA (public corporations)
 - State Leadership Accountability Act (SLAA, formerly FISMA)
 - Institute of Internal Auditors

State Leadership Accountability Act

- June 2015 (Update of 1963 Financial Integrity and Manager's Accountability Act)
- Instituted various internal control requirements
 - Maintain effective system of internal accounting and administrative control
 - Evaluation of those systems
 - Involvement of management at all levels to minimize fraud, errors, abuse, and waste of funds
- Report to certify adequacy of the control every other year
 - Now Management's responsibility to attest to the internal controls; used to be the internal auditor's responsibility

Financial Reports and Guidance

- Many types of Financial Reports
 - Financial Statements presented to Board Finance & Administration Committee in November
- CalPERS year-end financial reports (the ones that get audited and presented to the board for approval) must follow Generally Accepted Accounting Principles, called “GAAP” (just like public companies)
- Who sets GAAP for CalPERS? The Governmental Accounting Standards Board, or the GASB
 - The Financial Accounting Standards Board sets GAAP for public and other for-profit organizations

Comprehensive Annual Financial Report

- Government financial statements that comply with GAAP as promulgated by GASB
- Typically not presented to Board in full
 - Financial statements are presented and approved
- Outcome of Herculean effort
 - Government Finance Officers Association gives an award if the CAFR is organized, readable, and complies with Governmental Accounting Standards Board
- Contains much discussion by management in addition to financial statements (MD&A)



Government Finance Officers Association

Certificate of
Achievement
for Excellence
in Financial
Reporting

Presented to

**California Public Employees'
Retirement System**

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended

June 30, 2013

Jeffrey R. Egan
Executive Director/CEO

Comprehensive Annual Financial Report

- Board members are encouraged to read the [CAFR](#)
- CAFR is useful for identifying various risks facing an organization, around which a risk mitigation apparatus can be built
- CAFR discusses CalPERS internal controls and risk mitigation strategies

Governmental Accounting Standards Board Recent Activity

- Statement 68 (affects employers)
 - First time to report a net pension liability if promised benefits < available assets
 - Challenge for employers to know their proportionate share
 - Discussion: How will CalPERS assist employers in estimating their proportionate shares?
- Statement 72 (FY 15-16 CalPERS statements)
 - Fair Value Measurement
 - Some investments previously carried at entry prices will now have to be valued at fair or exit prices
 - Primarily financial instruments, derivatives, swaps, but also real estate
 - Thinly traded markets makes valuation challenging

Governmental Accounting Standards Board 74 and 75

- Statements 74 (plan) and 75 (employer) on the horizon
- Parallel to Statements 67 and 68, but for postemployment (retirement) benefits other than pensions (e.g.: Healthcare, Dental, Life Insurance, etc.)
- Will require reporting of net liabilities for promised benefits
- Will require 20yr Muni rate for discounting unfunded liabilities (blended rate for partially funded)
 - 74: after 6/15/2016 (CalPERS July 1, 2016 start)
 - 75: after 6/15/2017 (CalPERS July 1, 2017 start)

Governmental Accounting Standards Board 74 and 75 (cont'd)

- Board should be informed about transition to new standards and effects on CalPERS financial statements
- Also become informed about effects on employer financial statements
 - Possible effect on capital market access
 - How much has been put away for healthcare vs. expected future costs?
- California Employer's Retirement Benefit Trust Fund (CERBT)
 - Permits employers, at their option, to pre-fund non-pension related obligations (healthcare, etc.)
 - CalPERS role as custodian of funds on behalf of employers
 - Started in 2007, has over 450 current participants

Board Oversight of Financial Reports

- CalPERS financial statements presented to Finance and Administration Committee in November
 - Audit results reported to Risk and Audit committee also in November
- Discussion with management about:
 - Effect of new accounting pronouncements
 - Significant changes in account balances/amounts from prior year
 - What to look for next year
 - Accountants tend to view the world negatively (we focus on errors and not so much what is correct)



Audits

Office of Audit Services

- Internal Audits is the Board's lens into the organization
 - Although Internal Audits is part of the organization, the internal auditing standards require the function to maintain organizational independence by reporting to the board
 - Professional standards give backbone to the process

Audit Services Division Chief

- An important part of the management team, but nonetheless has a watchdog role over management
- Knows and adheres unbendingly to required standards
- Meets directly with the Board on a regular basis
- Administratively reports to General Counsel
- Board should empower the Chief to provide unvarnished reliable information to the Board

Role of Audits

- Audits should not be viewed as a “gotcha”
- Audits should become an integral part of a risk management system that provides significant benefit to the organization
- Audits provide an opportunity for improvement and reflection
- Audits increase public trust and confidence
- Important to clearly communicate the benefits of an audit to those being audited
 - Why it is in their best interest to be audited

Risk and Audit Committee

- Oversees system soundness, enterprise risk management, internal and external audits, privacy and information security, ethics, compliance, and other independent reassurance activities
- Necessitates board reliance on those with technical knowledge
- Common practice to identify a specific “Financial Expert” on the committee
 - Follows similar requirement for publicly traded companies

Auditing Process and Outputs

- Constitute the third line of defense
 - The end of the road...
- Primary purpose is not any specific tangible output per se
 - Purpose is regulatory and also “peace of mind”
- Valuable by-product is advice from auditor regarding financial reporting system and controls

Cost and Benefit of Audits

- Audits consume not only auditor time, but also other employee time, which reduces time available to perform primary tasks
- As with internal control systems, the choice of how many and which audits to do is often driven by a cost benefit analysis
 - Auditing resources are not unlimited: choices must be made
 - Not every employer can or should be audited
 - Not every CalPERS operation/function can or should be audited
- Why?
 - Costs > benefits
 - Opportunity cost of doing a higher risk audit instead

Risk Based Audit Plan

- Two year plan presented to Board (Risk & Audit Committee) for approval at the June meeting
- Audit plan should map into a formal discussion of:
 - Auditable entities
 - Risk of each entity (loss x probability)
- Risk assessment is critical
 - Impractical to audit everything
 - Board must accept the tradeoff, this is the heart of the level of acceptable risk
- Boards should be involved with the audit planning process, including approving the annual audit plan

Public Agency Reviews

- Roughly 100 standard and 25 targeted reviews each year of the roughly 3300 public agencies
 - Identify recurring audit findings, and communicate back to the agencies (close the loop)
 - Reward agencies with few findings or improved results?
- 50 or so internal audits per year

Public Agency Compliance Reviews

- Compliance with applicable sections of the California Government Code, Public Employees' Pension Reform Act, California Code of Regulations
 1. **Compensation** (payrate, compensation earnable, special compensation, pay schedule, and contributions)
 2. **Membership** (enrollment of eligible and ineligible members, and timely enrollment)
 3. **Payroll reporting** (incorrect payroll information: work hours, payrate, earnings)
 4. **Working after retirement** (unlawful retirement, excessive payrate, misclassification as independent contractor)
 5. **Unused Sick Leave** (incorrect certification of unused sick leave of retiring members)
- Compliance with reporting and enrollment procedures as they relate to a public agency's contract with CalPERS

Fiduciary responsibility over the pension funds...
benefits should be calculated timely and accurately.

IT Audits

- Physical access to secured areas is controlled and monitored to prevent unauthorized access to systems
- User access to systems is properly authorized and configured to limit access commensurate with responsibilities
- System activities are monitored to prevent unauthorized access and activities
- Production data is sanitized by removing confidential information before use in testing
- Data are removed prior to equipment disposal

Internal Controls designed to safeguard technology assets and provide authorized access.

Internal Audits, Investment and Health, and Consulting

- Internal Audits
 - Include Internal Control reviews regarding financial reporting, compliance with regulations, and safeguarding of assets
- Investment and Health Audits
 - Include compliance with reporting requirements and operating agreements
- Consulting
 - Consult with management on ad hoc requests as needed

Efficiency and effectiveness of operations, safeguarding of assets, and financial reporting

Internal Audit Objectives

- Provide management and the Board with assurance and information to help them accomplish the organization's objectives
- Audit Plan
 - Priorities for allocating internal audit resources
 - Input from senior management and the Board
- Focus on high risk areas
 - Inherent risk
 - Residual risk
 - Control systems organization relies on
- Internal Audit Activities
 - Control reviews
 - Inquiries
 - Consulting activities

OFAS is here to answer your questions related to risk areas.....that keep you up at night!

External Financial Statement Audit

- Independent Auditor's Report
 - Audit opinion (November Risk & Audit Committee)
 - Financial Statements (November Finance & Administration Committee)
- Report to those Charged with Governance
 - CalPERS Risk & Audit Committee
- Report on Internal Control over Financial Reporting (sometimes combined into a Management Letter)

Quality Assurance Review

- Review of internal audit function
 - Conducted every five years by independent external auditor (not financial statement auditors)
- Provides the Board with external independent review
 - Don't expect a zero-finding QAR
 - Should be viewed as a welcomed opportunity for improvement by internal audits
- Board should consider QAR findings carefully

Board Questions for Auditors

- Was management/staff cooperative?
- Was all requested documentation timely provided?
- Are there any remaining significant disagreements over financial reporting with management?
- Describe management's tone regarding the audit process?
- Is there any significant pushback on audits, and if so by who?
- Are there recurring problems?
- How serious is any particular finding (provide context)?
- Are management's corrective actions appropriate?
- When will the findings be "cleared"
 - CalPERS policy: put a plan in place within 1 year

Auditee Feedback to Board

- Those audited (CalPERS by external auditor, operating units and employers by internal auditor) should have formal feedback to the Board
- How effective/efficient was the audit process?
 - Agency/Employer private feedback to CFO
 - CFO closed session with Board
- Are there any improvements the auditor could make to enhance the efficiency and quality of the audits?

Some Auditing Thoughts

- Consider requiring public agencies to “self-review” recurring and high-frequency findings
 - Ask employers to annually self-review and report on specific items, such as creditable vs. non-creditable overtime
- Formalize reward systems for improvement
 - Simple as “CalPERS Certificate of Financial Reporting Achievement” for employers who show few (no) audit findings, and who show improvement over time

Thank You

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