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Summary of Financial Statement Audit Management Letter Comments
Current Year Report
As of June 30, 2015

Audit (Report Issue Date): Report to Management for the Year Ended 06/30/14 (2/25/15)

Observation #1:	Investment Valuation
Divisions responsible:	Financial Office/Investment Office

Observation: Investments are one of the most significant areas within CalPERS' basic financial statements, and the risk of material misstatement related to investment fair values are considered high. As part of the audit, we consider the appropriateness of the accounting methods used for measurement and disclosure, which includes understanding the process used by management in developing fair value estimates and the controls related to those estimates. During our audit of investment fair values, we noted the following accounting differences:

a. Real Estate Investments – The general partners are required to provide monthly or quarterly financial information to CalPERS, including the annual audited financial statements. In addition, the general partners are required to input monthly or quarterly financial information directly into the Automated Real Estate Information System (AREIS). CalPERS utilizes the general partners' financial information along with information posted in AREIS to record CalPERS' share of real estate investments in the general ledger. As part of the accounting and reconciliation process, Fiscal Services Division personnel verify that CalPERS' net asset values (NAV) reported in AREIS are consistent with the general partners' audited financial information. Verifying that partners' audited financial information has been properly reported in AREIS and ultimately CalPERS' general ledger is an essential part of internal control over the valuation of investments. Although timing and other differences between the partners' audited financial statements and CalPERS records are expected, our audit revealed two instances in which the general partners' audited financial statements differed from the amounts reported in AREIS and the general ledger. This was primarily due to the general partners' audited financial statements reflecting different valuation methodologies for certain properties.

b. Private Equity Investments – Effective in fiscal year 2013/2014, CalPERS changed its process to record estimated fair values for alternative investments (i.e. private equity and real assets). Under the new policy, the estimated fair values at June 30th are based on the general partners' March 31st financial information adjusted for cash flow activities through June 30th. In prior years, the estimated fair values reported in CalPERS' audited financial statements were based on the general partners' June 30th financial information. Our audit revealed that the unaudited estimated fair values for private equity investments reflected the general partners' March 31st financial information and were not adjusted for the cash flow activities through June 30th. As a result, an audit adjustment of approximately $864 million was recorded in CalPERS' audited financial statements, which decreased private equity investments and the related investment

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income as of and for the fiscal year ended June 30, 2014.

c. Securities Not Priced by the Custodian Bank – CalPERS relies on the custodian bank to value publicly traded securities; however, there are certain securities for which the custodian bank could not determine fair value primarily due to the securities no longer being traded in an active market. On a monthly basis, the custodian bank provides the Investment Office a listing of securities that have stale pricing, and the Investment Office is responsible for updating the pricing using external pricing sources. As part of the audit, we requested a listing of securities that were not priced by the custodian bank. We examined supporting documentation to substantiate the June 30th values on a sample basis. Our testing revealed two investments that were understated by approximately $60 million; however, this error was not corrected in CalPERS' audited financial statements as the amount was deemed immaterial. In addition, we ascertained that the improperly valued investments were structured in a limited partnership, and the original Note 14 to the basic financial statements excluded the disclosures of total and unfunded commitments for this partnership. The audited financial statements were subsequently revised to reflect these disclosures.

Financial Reporting and Accounting Services Current Update: OPEN.

a. The Investment Office has developed Real Estate Valuation Procedures for the real estate partners that state how valuation must be done: "All assets will be valued annually by an Independent Complete Appraisal Report with external independent oversight. Timing of the appraisal for each asset will be determined by the quarter in which the asset was acquired." This ensures that valuation is done in accordance with GAAP and GASB. The Financial Office in partnership with the Investment Office have created Real Estate Accounting Procedures for external managers. CalPERS has prepared these accounting procedures in order to provide standards and guidelines for external real estate managers. This guidance is provided to facilitate consistency in accounting and reporting information to CalPERS. This includes reporting real estate investments at fair value under the Operating Model guidelines. The Office of Audit Services manages audits of real assets general partners and property managers by the Board approved real assets audit firms and has updated its agreed-upon audit procedures to include verification that general partner's valuation policy is consistent with CalPERS valuation policy and is reflected in the notes to the general partner's audited financial statements

b. The Private Equity Unit has updated their year-end procedures for Fiscal Year 2014-15. The PEARS project continues with parallel activities and is now scheduled for a go live date of October 1, 2015.

c. The Investment Office has developed procedures to identify and value securities not priced by the custodian bank. The Financial Office has developed procedures to review and verify pricing of funds reported at NAV to the custodian bank.

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Observation #2:	Actuarial Discount Rate Determination
Division responsible:	Actuarial Office

Observation: In fiscal year 2013/2014, the System implemented GASB Statement No. 67, *Financial Reporting for Pension Plans - An Amendment of GASB Statement No. 25* (Statement). The objective of this Statement is to improve financial reporting primarily through enhanced note disclosures and schedules of required supplementary information for defined benefit pension plans. One of the requirements of this Statement is that projected benefit payments are to be discounted to their actuarial present value using a single discount rate that reflects the long-term expected rate of return on pension plan investments that are expected to be used to finance the payment of benefits, to the extent the pension plan's fiduciary net position is projected to be sufficient to make projected benefit payments and pension plan assets are expected to be invested using a strategy to achieve that return. Paragraph 44 of the Statement states, "the long-term expected rate of return should be determined net of pension plan investment expense but without reduction for pension plan administrative expense." We noted the long-term expected rates of return used by the Actuarial Office for the schools (PERF B) and public agency (PERF C) pools, the Legislators Retirement Fund (LRF), and the Judges Retirement Fund II (JRF II) were determined net of administrative expenses, which does not conform to U.S. GAAP. Had the long-term expected rates of return been calculated without reduction for administrative expenses, our actuarial consultant estimated, based on information provided by CalPERS' actuaries, that the net pension liabilities for the PERF B, PERF C, LRF, and JRF II disclosed in Note 7 to the basic financial statements would be reduced by approximately $1.1 billion, $509.1 million, $2.8 million, and $15.8 million, respectively, which is not considered material to the respective plans.

Actuarial Office's Current Update: OPEN. CalPERS is scheduled to review all actuarial assumptions as part of its regular Asset Liability Management (ALM) review cycle that is scheduled to be completed in February 2018. Any changes to the discount rate will require Board action and proper stakeholder outreach. For these reasons, CalPERS expects to continue using a discount rate net of administrative expenses for GASB 67 and 68 calculations through at least the 2017-18 fiscal year. CalPERS checked the materiality threshold for the difference in calculation and did not find it to be a material difference. CalPERS will continue to check the materiality of the difference in calculation until such time as we have changed our methodology.

Observation #3:	Member Census Data
Division responsible:	Actuarial Office/Customer Services and Support

Observation: In accordance with GASB Statement No. 67, *Financial Reporting for Pension Plans – An Amendment of GASB Statement No. 25* (Statement), the actuarial information for single employer and multiple-employer cost-sharing defined benefit pension plans is disclosed in the notes to CalPERS' basic financial statements. In light of the new GASB pension standard, the American Institute of Certified Public Accountants issued guidance related to the testing of

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single and cost-sharing employer census data, including active member census data maintained by employers, which is critical in the determination of the required actuarial information disclosures. During the fiscal year 2013/2014, we examined census data for the following reporting funds with the assistance of the Office of Audit Services:

- PERF B (Schools Cost-Sharing Plan)
- PERF C (Public Agency Cost-Sharing Plan)
- Legislators Retirement Fund or LRF (Single-Employer Plan)
- Judges Retirement Fund I or JRF I (Single-Employer Plan)
- Judges Retirement Fund II or JRF II (Single-Employer Plan)

We performed a risk assessment over the cost-sharing plans to determine which employers would be selected for census data testing. For the selected employers, we examined census data for retired, inactive, and active members on a sample basis.

As part of preparing the annual actuarial valuation reports for the employers, ACTO transfers census data from my|CalPERS to the Actuarial Valuation System (AVS) and completes a process of data review and clean-up prior to running the valuation reports. Our testing of census data for retired and inactive members includes testing the accuracy of significant data elements between my|CalPERS and AVS. For active members' census data, our testing includes procedures to verify the significant data elements from AVS to the participating employers' payroll records to determine that the census data used in the actuarial valuations is complete and accurate. Significant census data elements include: date of birth; date of hire or years of service; marital status; eligible compensation; benefit amount, member account balance, class of employee; gender; date of termination or retirement; spouse date of birth; and employment status (active, inactive, retired).

For the Schools and Public Agencies Cost-Sharing Plans, we examined a total of 630 active members from the 21 selected school districts and a total of 400 active members from the 16 selected public agencies, respectively. Our procedures revealed numerous discrepancies in census data between AVS, my|CalPERS, and the employers' records. The discrepancies we identified involved annual compensation, special compensation, hire date, employment status, birthdate, gender, name, and total active member counts. We provided a listing of discrepancies to CalPERS' management to review and address. In addition, we engaged an actuarial consultant to determine the impact of the census data discrepancies to the actuarial disclosure information, including the net pension liability. The determination of the impact was based on the demography of the cost-sharing pools under consideration, taking into account sensitivities of estimated net results to changes in methodology and demographic data. Based on high-level estimates and extrapolating the nature of the discrepancies noted, our actuarial consultant projected the impact to each cost-sharing plan to be less than .5% of the net pension liabilities for the related plans as of June 30, 2014.

Actuarial Office and Customer Services and Support Branch's Current Update: OPEN. The Actuarial Office recently established a procedure that details our methods for correcting errors in the source data in my|CalPERS and will continue to utilize this process. There are

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instances where data elements in AVS purposely do not match those in my|CalPERS due to the system limitations and design of each system. For example, date of hire or annual benefit compensation is changed in AVS to reflect purchase of additional service credit. This will result in future discrepancies that won't be corrected. CalPERS' Customer Services and Support Branch will continue to work through employers correcting census data discrepancies as they are identified through staff's ongoing work processing and by proactively verifying member information within my|CalPERS through CalPERS employer reviews.