CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Letter

Fiscal Year Ended June 30, 2015

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Management Letter

Fiscal Year Ended June 30, 2015

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________, 2016

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, 2015, 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 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.

However, during our audit we became aware of deficiencies in internal control other than significant deficiencies and material weaknesses and matters that are opportunities for strengthening internal controls and operating efficiency. The current year comments and recommendations are included in the Current Year Comments and Recommendations section of this letter. The status of the prior years' comments and recommendations is included in the Prior Years Comments and Recommendations section of this letter.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and suggestions with appropriate CalPERS personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

CalPERS' written responses to the current and prior years' comments and recommendations have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

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

California Public Employees' Retirement System
Management Letter
Current Year Comments and Recommendations
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Fiscal Year 2014/2015 Observation #1 – Investment Valuation

As part of our audit, we consider the appropriateness of the accounting methods used for measurement and disclosure of investments, 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 items:

a. We selected a sample of real asset appraisals completed by external appraisal firms in order to verify that the appraised real asset property value is properly reflected in the partnership's financial statements, which are used by CalPERS to report the fair value of real asset investments. As part of the reconciliation process, the Investment Portfolio Analytics (IPA) Unit within the CalPERS Investment Office (INVO) is responsible for verifying that the partnership reflects the appraised value in their financial statements. Our testing revealed the following items:

    1. The IPA Unit was unable to reconcile the appraised value of certain selected investments to the partnerships' financial statements due to complexities in the ownership structure of the funds. The IPA Unit provided information regarding the unreconciled investments to the respective CalPERS Portfolio Manager (PM) and requested the PM to follow-up with the general partners. However, the IPA Unit does not have a formal process to ensure that the unreconciled investments are addressed and resolutions are documented.

    2. The IPA unit utilizes a third-party consultant, Altus, to compile the results of the appraisals for comparison to the partnerships' financial statements. Part of the IPA Unit's process related to the appraisal reconciliation is to select a sample of appraisals to verify that the correct values are utilized by Altus. We noted that Altus erroneously entered the appraised value for one of the selected properties in Australian Dollars as opposed to U.S. Dollars. The IPA unit compared the appraised value in Australian Dollars to the value reported in the partnership's financial statements presented in U.S. Dollars as the investment in question was not part of the IPA Unit's verification selections.

b. CalPERS holds certain securities that cannot be priced by the custodian bank primarily due to unique private investment structures and stale pricing. The respective Asset Class Unit within INVO is responsible for evaluating the investments and obtaining the most recent available pricing from other external pricing vendors. As part of the investment fair value testing, we examined a sample of these investments to ensure that the fair values recorded in CalPERS' financial statements are reasonable based on management's determination of fair value. Although we did not note errors for the selected transactions, we noted that there were investments with stale pricing dating from 2011 and one investment which was last priced in 1970. INVO currently has stale price procedures, and the established procedures are operating as designed. However, INVO should establish procedures with specific guidelines pertaining to the write off of securities that have not been priced for a prolonged period of time. In addition, INVO should reevaluate and revise the established guidelines on an annual basis, as appropriate to ensure proper reporting of fair value as of CalPERS' fiscal year end.

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Fiscal Year 2014/2015 Observation #1 – Investment Valuation (Continued)

c. CalPERS reports private equity investment fair values based on the partnerships' March 31st financial information adjusted for cash flow activities from April through June. Certain private equity partnerships are publically traded, and CalPERS values these investments based on the number of shares owned and pricing available as of March 31st. Public company investments should be valued based on the shares and pricing data as of June 30th for financial reporting purposes as that information is available during the financial statement closing process.

Recommendation:

As a result of investments being one of the most significant areas in CalPERS' basic financial statements, and there is a risk of material misstatement related to investment fair values, the Financial Office (FINO) should work with INVO to re-evaluate the current processes and procedures related to reconciliations and the determination of fair value of certain investment transactions for accounting and financial reporting purposes. In February 2015, the Governmental Accounting Standards Board (GASB) issued Statement No. 72, *Fair Value Measurement and Application* (Statement). The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015. This Statement addresses accounting and financial reporting issues related to fair value measurements. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. The requirements of this Statement will enhance comparability of financial statements among governments by requiring measurement of certain assets and liabilities at fair value using a consistent and more detailed definition of fair value and accepted valuation techniques. This Statement also will enhance fair value application guidance and related disclosures in order to provide information to financial statement users about the impact of fair value measurements on a government's financial position. FINO should work with the custodian bank and INVO to evaluate CalPERS' investments and determine the proper applicability of the requirements of this Statement.

Management Response:

a. The investments in question represent non-controlling interests in a joint venture structures held in one of CalPERS' separate accounts. IPA is updating its valuation procedures to clarify that for non-control positions, the partner is responsible for providing valuations under an approved policy. IPA will no longer be requesting appraisals for such investments as part of standard process. This information will be reviewed to ensure appraisal information is represented at fair value, by October 31, 2016.

   IPA has revised its appraisal review procedures to include an explicit check on currency reporting, even in cases where the variance falls below flagging thresholds. In addition, IPA is following up with Altus to ensure appropriate quality control procedures for appraisal data entry are in place, by October 31, 2016.

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Fiscal Year 2014/2015 Observation #1 – Investment Valuation (Continued)

Management Response (Continued):

b. With the implementation of GASB Statement No. 72, we will be evaluating our policy and procedures related to stale pricing. The policy will be reviewed to ensure prices are evaluated on a regular basis to ensure securities are written off timely. By June 30, 2016, the procedures will be reviewed and updated, as necessary, to ensure prices reflect fair value at the fiscal year-end.

c. With the implementation of GASB Statement No. 72, the Financial Office will develop procedures to evaluate private companies that become public and determine the accounting treatment of these transactions. This will be implemented in fiscal year 2015-2016.

Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures

Total and unfunded commitments related to investments in limited partnership structures are disclosed in CalPERS' basic financial statements. As part of the audit, we selected a sample of transactions and performed various audit procedures and noted discrepancies as follows:

a. The draft note disclosure included total commitments for real asset and private equity partnerships that did not have any outstanding unfunded commitment balances. Once all commitments have been funded, the original total commitment should be removed from the disclosure.

b. The draft note disclosure included total commitments for private equity partnerships that became publically traded. As a result of being publicly traded, there are no outstanding unfunded commitments for these entities as they are no longer structured as limited partnerships.

c. For real asset investments, FINO relies on the information generated from the Automated Real Estate Information System (AREIS) for the total and unfunded commitment disclosure. Total and unfunded commitments within AREIS are based on the transactions posted by the general partners. We noted the following:

    1. The general partners erroneously entered two distributions in AREIS, which resulted in the misstatements in the total unfunded amount. Based on discussion with INVO personnel, there is no process in place to reconcile the total and unfunded commitment balances reported in AREIS to the general partners' capital account statements.

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Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures (Continued)

2. The total unfunded commitment amount for one partnership was incorrectly reflected in AREIS due to a time lag in the posting of capital contributions made on June 30, 2015. The unfunded commitment balance per the general partner's confirmation reply was less than the amount reported in AREIS as there were four capital call transactions remitted to the general partner, which were not reflected in AREIS as of June 30, 2015.

3. The total commitment reflected in AREIS should include all projects committed by CalPERS. For one partnership, the total capital commitments reported in AREIS reflected only the partnership's specific projects that were outstanding or in progress at year-end and excluded amounts related to completed projects.

d. For private equity investments, FINO relies on the information provided by the Private Edge Group for the total and unfunded commitment disclosure. We noted the following:

1. The total commitment for one investment partner was overstated as the original commitment amount was reduced as agreed upon by CalPERS and the general partner, and the reduced commitment was not reflected in the detail provided by the Private Edge Group and the original note disclosure.

2. For one partnership, the unfunded commitment amount reported by the Private Edge Group differed from the amount confirmed by the general partner due to a clerical error.

3. The total commitment disclosure improperly included three transactions, which relate to non-discretionary custom accounts. For non-discretionary custom accounts, CalPERS has discretion over the amount to be funded, despite the initial total commitment. As such, these amounts do not represent contractual obligations and should not be included in the note disclosure.

Recommendation:

FINO should review each partnership with total and unfunded commitment disclosures and evaluate the nature of the transactions to determine whether the disclosures are accurate. In addition, FINO should implement a verification process to agree the total and unfunded commitment amounts from AREIS and the Private Edge Group reports to the partnerships' records (i.e. capital account statements) on a sample basis, at a minimum.

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Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures (Continued)

Management Response:

Management concurs with the recommendation. By October 31, 2016, the Financial Office will document accounting treatment to better define the disclosure information, which will provide clarity to the process. The Financial Office will work with the Investment Office to develop procedures to produce and verify the information.

Fiscal Year 2014/2015 Observation #3 – my|CalPERS Functionality

As part of our testing of employer contributions, we noted instances of employers with active members (also known as Active Appointments) that did not report any active member payroll during the fiscal year. One of the reasons was due to employers ending their contract with CalPERS or rolling into another division organization ID number; however, the employer did not separate the underlying active members. There were also instances in which employers exist in my|CalPERS multiple times and have more than one my|CalPERS ID number.

Recommendation:

The resolution of this observation requires a coordinated effort between the various divisions within CalPERS in conjunction with working with the affected employers. CalPERS should establish a plan to address these issues in order to increase data integrity within my|CalPERS.

Management Response:

Management concurs with the recommendation. As part of the my|CalPERS Functional Optimization project, we will be creating reports for employers that identify the data issues, specifically the appointment data for them to correct. The target date for implementation is December 31, 2016.

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Fiscal Year 2013/2014 Observation #1 – Investment Valuation

Investments are one of the most significant areas within CalPERS' basic financial statements, and the risk of material misstatement related to investment fair values is 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 income as of and for the fiscal year ended June 30, 2014.

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<u>Fiscal Year 2013/2014 Observation #1 – Investment Valuation (Continued)</u>

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 (INVO) a listing of securities that have stale pricing, and INVO 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.

Recommendation:

Given the significance and sensitivity related to investment fair values, CalPERS should enhance the following processes:

a. The partners' audited financial statements are among the highest quality evidence to support management's estimate of the fair values of investments that are not publicly traded. CalPERS should identify all investments for which audited financial information differs from CalPERS' records and enhance current procedures to review the general partners' valuation methodologies in order to ensure that the fair values reported by CalPERS are accurate.

b. CalPERS should establish internal controls to ensure proper implementation of and adherence to new accounting and financial reporting processes.

c. CalPERS should strengthen current internal control over the valuation of securities not priced by the custodian bank in order to ensure proper accounting and reporting.

Management Response:

Management concurs with the recommendations and will work to enhance our processes with the below responses. This will all be implemented by the start of the new fiscal year, July 1, 2015.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
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Fiscal Year 2013/2014 Observation #1 – Investment Valuation (Continued)

Management Response (Continued):

a. For Real Estate Partnerships that provide audited financial information based on historical cost methodology of accounting, CalPERS will create and enforce a process that will be compliant per the recommendations provided. CalPERS will review Partner audited financial information based on historical cost methodology. This will ensure that audited financial statements are being reviewed and are following generally accepted accounting principles (GAAP). CalPERS will also review Partner non-audited financial information based on fair value methodology to ensure GAAP is being followed. Finally, CalPERS will require Partners to provide documentation that clarifies and supports the differences in NAV between the two accounting methodologies. Furthermore, CalPERS will have auditors go out to various General Partners to validate that fair values reported in the partners' quarterly financial statements and AREIS are supported by appropriate valuation reports. This will give CalPERS a better understanding of what is being provided by the General Partners. This will not only provide an extra sense of comfort that financials are accurate but also validate that accounting entries are being properly recorded.

b. CalPERS will review and enhance internal procedures to ensure adequate internal controls exist with respect to implementation and adherence to all new accounting and financial reporting processes. All new processes will have an additional layer of review and approval to ensure accurate implementation. CalPERS is currently in the process of implementing a new Private Equity Accounting and Reporting Solution (PEARS) which will give us additional management and oversight tools. The new solution provides comprehensive accounting, reconciliation and reporting of the Private Equity asset class at a much more detailed level and with greater reconciliation and reporting capabilities than previously available.

c. For certain securities which the custodian bank cannot determine fair value; CalPERS will implement processes that are compliant per the recommendations that were provided. On a monthly basis, the custodian bank provides the Investment Office (INVO) a listing of securities that have stale pricing. INVO will review the stale prices and update the pricing using external pricing sources. In addition, the Financial Office (FINO) will review financial statements from General Partners to ensure CalPERS financial statements correctly reflect the net asset value.

Fiscal Year 2014/2015 Status:

During the fiscal year 2014/2015 audit, we noted these observations were addressed. As such, we consider this recommendation to be implemented.

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Management Letter
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Fiscal Year 2013/2014 Observation #2 – Actuarial Discount Rate Determination

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 (ACTO) 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.

Recommendation:

CalPERS should utilize a long-term expected rate of return that complies with the requirement of GASB Statement No. 67, *Financial Reporting for Pension Plans - An Amendment of GASB Statement No. 25* to project the present value of future benefit payments in determining an appropriate discount rate.

Management Response:

CalPERS agrees that the long-term expected rates of return used for the PERF B, PERF C, LRF, and JRF II were determined net of administrative expenses, which does not conform to U.S GAAP. CalPERS also agrees with the estimated impact on the net pension liability for all funds as described in the observation.

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.

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<u>Fiscal Year 2013/2014 Observation #2 – Actuarial Discount Rate Determination (Continued)</u>

Fiscal Year 2014/2015 Status:

This recommendation was implemented during the fiscal year 2014/2015.

<u>Fiscal Year 2013/2014 Observation #3 – Member Census Data</u>

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 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 Agency 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.

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Fiscal Year 2013/2014 Observation #3 – Member Census Data (Continued)

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.

Recommendation:

Since the actuarial information disclosed in the notes to the basic financial statements is dependent on census data, CalPERS should update my|CalPERS to correct the known errors resulting from the audit, as appropriate. In addition, management should consider enhancing the current processes and controls to improve the completeness and accuracy of census data as it is a critical component in determining the actuarial information that is reported in CalPERS' audited financial statements and provided to the participating employers.

Management Response:

CalPERS concurs with the finding and the recommendations. 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 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.

Fiscal Year 2014/2015 Status:

During the fiscal year 2014/2015, the Office of Audit Services (OAS) assisted with the testing of active member census data for the cost-sharing multiple-employer and single-employer defined benefit pension plans administered by CalPERS. Consistent with the prior year, we performed a risk assessment over the cost-sharing plans to determine which employers would be selected for active member census data testing. The results of the testing revealed discrepancies between the employers' records and my|CalPERS, and discrepancies between my|CalPERS and AVS, which were not material to the respective defined benefit pension plan's total pension liability.

Fiscal Year 2013/2014 Observation #3 – Member Census Data (Continued)

Fiscal Year 2014/2015 Status (Continued):

In fiscal year 2014/2015, OAS worked with appropriate CalPERS divisions and employer personnel to address the identified discrepancies. We do not expect the active member census data to be 100% accurate due to inherent errors in employer reporting; however, enhanced procedures implemented by OAS to address the identified discrepancies will increase member census data integrity. Effective fiscal year 2015/2016, OAS, FINO and ACTO will work together to evaluate the impact of the identified discrepancies on the respective defined benefit pension plan's total pension liability.

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.

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<u>Fiscal Year 2012/2013 Observation #2 – Member Census Data (Continued)</u>

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.

Fiscal Year 2013/2014 Status:

This recommendation will be implemented in fiscal year 2014/2015.

Fiscal Year 2014/2015 Status:

The formal process was implemented during the fiscal year 2014/2015.

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

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 re-evaluated 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.

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

Recommendation:

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.

- 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.

Fiscal Year 2011/2012 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

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Management Letter
Status of Prior Years Comments and Recommendations (Continued)
Fiscal Year Ended June 30, 2015

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

Fiscal Year 2011/2012 Management Response (Continued):

- 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.

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 2012/2013 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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Management Letter
Status of Prior Years Comments and Recommendations (Continued)
Fiscal Year Ended June 30, 2015

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

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 AREIS 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.

Fiscal Year 2013/2014 Status:

During the fiscal year 2013/2014 audit, we noted the following errors related to investment commitment disclosures in Note 14 to the basic financial statements:

- The original financial statement disclosures of total and unfunded commitments for corporate governance strategy investments within the global equity investment portfolio included commitments that CalPERS has no intention of funding. CalPERS' financial statements were subsequently revised to properly exclude the total and unfunded commitment balances from the disclosures.

- The original financial statements included disclosures of total commitments for real asset investments that CalPERS is no longer obligated to fund due to a change in the investment partnership and the commitment structure. CalPERS' financial statements were subsequently revised to properly exclude these commitments from the disclosures.

- There were two instances of private equity partnerships that had gone public and for which commitment disclosures were included in Note 14, but were no longer applicable. CalPERS' audited financial statements were revised to exclude the total original commitment amount for one of the partnerships. For the other partnership, no revision was made as the original commitment amount was deemed immaterial to the overall financial statements.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Management Letter
Status of Prior Years Comments and Recommendations (Continued)
Fiscal Year Ended June 30, 2015

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

Fiscal Year 2013/2014 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, 2015. The Investment Office will enhance these processes by implementing the following steps:

- Implement new steps within the review process that requires the Private Equity, Real Asset, Corporate Governance and Global Fixed Income management to disclose any changes in investment structure (e.g. private investments going public) that impact their reported total commitment and unfunded amounts.

- In addition, the review process will also require the program area management to represent that any commitment or unfunded amounts that they have no legal obligation to fund are not included in the summary 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 2015.

Fiscal Year 2014/2015 Status:

Refer to fiscal year 2014/2015 observation #2 for current year observations.