CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Letter

Fiscal Year Ended June 30, 2017

MGO Certified Public Accountants

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Certified
Public
Accountants

________, 2017

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, 2017, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, 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. We have also issued our report dated ____, 2017 on internal control and compliance required by *Government Auditing Standards.*

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 Year 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.

Management's 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

<u>Fiscal Year 2016/2017 Observation #1 – Service Organization Control (SOC) Reports</u>

CalPERS engages service organizations to process and account for transactions that are significant to the administration and financial reporting of CalPERS investment, pension, health and long-term care activities. Statements on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization,* and AICPA AT-C Section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting,* which is effective for reports dated on or after May 1, 2017, provide guidance regarding examinations and related reports on controls at service organizations. One of the most effective ways a service organization can communicate information about the service organization and its control environment is through a Service Organization Control (SOC) 1 (SOC 1) report. A SOC 1 Type 2 report focuses on controls at the service organization that would be useful to user entities' internal control over financial reporting and includes an examination report on management's description of the suitability of the design and the operating effectiveness of the controls. CalPERS, as a user entity, requests SOC 1 Type 2 reports from certain third-party service organizations on an annual basis. However, CalPERS does not have processes or procedures in place related to the following:

- Identification of all third-party service providers that have a direct impact on CalPERS' accounting and financial reporting,
- Tracking of timely receipt and review of SOC 1 Type 2 reports,
- Review and evaluation of SOC 1 Type 2 reports to determine whether findings noted could have a direct impact on CalPERS' financial reporting, and
- Determination of whether CalPERS has the required complimentary user entity controls in place, and whether those controls are operating effectively.

Recommendation:

CalPERS should implement formal procedures related to the identification, receipt, and review of SOC 1 Type 2 reports for third-party service organizations that have a direct impact on CalPERS' financial statements. In addition, the Financial Office should review each SOC 1 Type 2 report along with the provisions of AT-C 320 to understand the scope and objectives of SOC 1 Type 2 engagements and to evaluate whether CalPERS' user entity controls are sufficient to compliment service organization controls.

Management Response:

Management concurs with the recommendation. A formal process will be created to identify third-party service providers with potential impact on financial reporting, standardize the review and analysis of SOC 1 reports, and ensure CalPERS has required complimentary user entity controls in place. Financial Reporting and Accounting Services (FRAS) will collaborate with other divisions of CalPERS to create the comprehensive list of all vendors engaged in work related to the standard, and confirm a SOC 1 report has been received. FRAS will also review the reports, evaluate the impact to the financial statements, and determine whether proper controls are in place to mitigate any possible issues identified. In compliance with SSAE 16, FRAS will confirm that there are appropriate user controls with our third-party service providers; such as timely removal of user accounts, secure data sharing, and system access controls. The target date for implementation is July 31, 2018.

Fiscal Year 2016/2017 Observation #2 – Accounting and Reporting for OPEB Contributions and Reimbursements Outside of the California Employers' Retiree Benefit Trust Fund (CERBTF)

Governmental Accounting Standards Board (GASB) Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, requires an Other Postemployment Benefits (OPEB) plan to report on all activities of the OPEB plan, and not solely the activities of the trust through which the OPEB plan is administered. Further, GASB Statement No. 74 requires that contributions from employers include amounts for OPEB as the benefits come due, including amounts that will not be reimbursed to the employers using OPEB plan assets. In addition, benefit payments should include benefit amounts paid directly by employers. In this circumstance, an amount equal to the benefit payments is recognized both as an addition to and a deduction from OPEB plan fiduciary net position. The System records this type of activity as Employer Contributions Outside of Trust – OPEB and OPEB Reimbursements – Outside Trust in the CERBTF statement of changes in fiduciary net position. In order to quantify benefits paid by employers outside of the trust, CERBTF Program personnel obtain this information from participating employers as part of year-end closing procedures. Contributions and reimbursements made outside of the trust are calculated as the sum of retiree healthcare premiums and implicit rate subsidies, net of any reimbursements made directly from the trust. As part of our testing, we noted the following errors, which resulted in audit adjustments:

- For 15 employers, there were errors in the implicit rate subsidy used in the calculations.
- For 10 employers, late and/or revised information submitted by the employers was not sufficiently reviewed for accuracy prior to making changes to the employers' original calculations.
- For three employers, calculations related to reimbursement amounts contained arithmetic errors.
- For two employers, the implicit rate subsidy was accounted for twice in the calculation.
- For two employers, the implicit rate subsidy used in the calculation pertained to an incorrect period.
- For one employer, CalPERS remitted an OPEB reimbursement that exceeded the employer's retiree healthcare premiums.

Recommendation:

CERBTF Program personnel working in conjunction with the Financial Office should strengthen the current procedures to ensure the completeness and accuracy of information submitted by employers. Since the accounting and financial reporting for contributions and OPEB reimbursements outside of the trust is dependent on the completeness and accuracy of information submitted by the participating employers, management should consider providing additional guidance and tools to employers to assist in the preparation of financial information required by CalPERS.

<u>Fiscal Year 2016/2017 Observation #2 – Accounting and Reporting for OPEB Contributions and Reimbursements Outside of the California Employers' Retiree Benefit Trust Fund (CERBTF) (Continued)</u>

Management Response:

Management concurs with the recommendation. The CERBT Program has implemented and will continue to implement procedures and processes to improve the accuracy and integrity of the financial reporting requirements under GASB 74 and 75. The CERBT Program is reliant on participating employers to accurately report their outside the trust premiums of their retirees. To improve this process, CERBT program staff will provide additional year-end financial reporting training to contracted employers via webinars and teleconferences. This training will include an element of discussion related to implicit rate subsidy, to ensure its properly reported to CalPERS.

As the GASB 75 audit for Fiscal Year 2015/16 was performed concurrently with the year-end financial reporting for Fiscal Year 2016/17, CERBT staff has implemented procedures in the review of the year-end reporting for the CERBT contracted employers. CERBT program staff performed a more detailed review of the "outside the trust" premiums reported in relation to the total disbursements for each employer to ensure disbursements did not exceed the reported outside the trust premiums. In addition, year-end contribution summaries received after the deadline will be reviewed for accuracy prior to any adjustments to the GASB 75 Statement of Changes in Fiduciary Net Position.

Lastly, to address the data entry errors, two CERBT program staff will perform reviews of the OPEB valuations and supporting documentation provided by the contracted employers. This will ensure the implicit rate subsidy, estimated premiums, and plan participant counts are entered accurately for CERBT Program tracking and reporting purposes.

With the additional training to the CERBT contracted employers in Spring 2018, and in subsequent years, the accuracy of the financial reporting will improve.

<u>Fiscal Year 2016/2017 Observation #3 – Accounting and Reporting for the Replacement Benefit Fund (RBF)</u>

CalPERS elected to early adopt the provisions of GASB Statement No. 84, *Fiduciary Activities*, effective July 1, 2016. GASB Statement No. 84 eliminates the agency fund type and creates a new fund type called a custodial fund. As a result, of the implementation, the RBF is now classified as a custodial fund and is required to present a statement of changes in fiduciary net position. During the audit, we noted the following items:

- The trial balance and reconciliations for the material RBF financial statement line items were not available for audit until mid-October.
- The original draft RBF financial statements contained misclassifications, which resulted in audit adjustments.
- Differences related to unearned replacement benefits recorded in the general ledger and my|CalPERS have not been corrected.

Although the Financial Office has improved reconciliation procedures, additional procedures are necessary to ensure RBF balances are complete and accurate.

Fiscal Year 2016/2017 Observation #3 – Accounting and Reporting for the Replacement Benefit Fund (RBF) (Continued)

Recommendation:

The Financial Office should continue to work with the appropriate CalPERS Division to reconcile account balances in the RBF and to ensure accuracy and consistency between the general ledger and my|CalPERS. In addition, the information for the RBF should be made available by early September to allow sufficient time for auditing procedures.

Management Response:

Management concurs with the recommendation. FRAS will update procedures to incorporate and improve internal controls as part of GASB 84 implementation, as well as make certain that all RBF balances are complete, accurate, and recorded timely. This will prevent future misclassifications and address reconciling items of RBF balances. This will also ensure that contributions/benefit payments and unearned replacement benefit payable are accurately recorded in the general ledger, and financial statements. These efforts will be in collaboration with other CalPERS divisions, in order to create consistency between the general ledger and the my|CalPERS system. The corrective actions will be implemented by July 31, 2018.

Fiscal Year 2015/2016 Observation #1 – Accounting and Reporting for Internal Pooled Investments

CalPERS implemented Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application* in fiscal year 2015/2016, which establishes general principles for measuring fair value and standards of accounting and financial reporting for assets and liabilities measured at fair value. As part of the implementation, the underlying securities held in CalPERS' internally pooled (unitized) investments are reported at fair value rather than at net asset value (NAV). We observed that unitized investments provided by the custodian bank are first recorded at NAV and then allocated to participating funds based on the respective fund's ownership percentage of the unitized portfolios. The Financial Office has to manually adjust the reported NAV in order to properly record the investment fair values and the related investment receivables and payables. The manual process is time consuming and prone to errors as the draft financial statements contained a misclassification between global debt securities and global equity securities, which was corrected in the audited financial statements.

Recommendation:

To enhance the current process, we recommend that the Financial Office work with the custodian bank to automate the accounting and recording for unitized investments.

Management Response:

The Financial Office concurs with this finding and has initiated a project with State Street Bank, our custodian, to automate the accounting and recording of the unitized investments. We are in the early stages of development and will have a working model by the end of December 2017. We have also started a project to enhance our current process, using macros and other automation tools to reduce the manual nature of the process and lower our risk of error. We will use this process in parallel with the automated tool.

Fiscal Year 2016/2017 Status:

During the fiscal year 2016/2017 audit, we noted these observations were addressed. As such, we consider this recommendation to be implemented.

Fiscal Year 2015/2016 Observation #2 – Replacement Benefit Fund Account Reconciliation

The Replacement Benefit Fund (RBF) was established to account for benefit payments to retirees whose retirement allowance exceeds the Internal Revenue Code (IRC) Section 415(b) limits. IRC Section 415(b) imposes a dollar limit on the annual retirement benefits an individual may receive from a qualified defined benefit pension plan. Employers are responsible for paying the excess benefit amounts for their former employees, CalPERS sends invoices to the respective employers for the portion of pension benefits exceeding the limits. Upon receiving payments from the employers, CalPERS remits the excess benefit portion to the respective retirees. The accounting and reporting for these types of transactions are custodial in nature and CalPERS reports a statement of fiduciary net position for the RBF. As part of the fiscal year 2015/2016 financial statement audit, we obtained the year-end reconciliation between the general ledger and my|CalPERS for the receivable from employers and payable to members and employers accounts. We noted the balances do not reconcile and that as part of the annual reconciliation process, the data in the reconciliation generated from my|CalPERS has to be manually adjusted.

Fiscal Year 2015/2016 Observation #2 – Replacement Benefit Fund Account Reconciliation (Continued)

Recommendation:

We recommend that the Financial Office should work with the appropriate CalPERS Division to ensure that data in the general ledger and my|CalPERS are consistent and the two systems properly reconcile.

Management Response:

The Financial Office concurs with this finding. The Financial Office currently reconciles the fund on a monthly basis to the receivable and payable general ledger account balances. We have identified and documented the discrepancies with the my|CalPERS report used for reconciliation and the data is in the process of being corrected. We are currently in development of a multi-phase system functional optimization scheduled early next year which will improve the overall data accuracy.

Fiscal Year 2016/2017 Status:

The Financial Office early adopted the provisions of Governmental Accounting Standards Board Statement No. 84, *Fiduciary Activities*, effective July 1, 2016, for the Replacement Benefit Fund. Refer to fiscal year 2016/2017 Observation #3 for our current year observation and recommendation.

Fiscal Year 2015/2016 Observation #3 – Long-Term Care Fund Annual Actuarial Valuation

On an annual basis, an actuarial valuation report is completed to determine the Estimated Liability for Future Policy Benefits for the Long-Term Care Fund. In fiscal year 2015/2016, the Actuarial Office (ACTO) prepared the annual actuarial valuation report (the report) based on member census data provided by the third-party administrator. The Financial Office utilizes the report to record the Estimated Liability for Future Policy Benefits in the Long-Term Care Fund and for financial statement disclosure purposes. The Estimated Liability for Future Policy Benefits is considered a significant estimate in the Long-Term Care Fund due to the sensitivity of the underlying actuarial assumptions and methods. The fiscal year 2015/2016 draft valuation results were available in mid-October, which created a challenge in meeting the established financial reporting and audit timeline of October 31st. In order to meet this deadline, the valuation should be completed no later than September 30th to allow sufficient time to complete the financial reporting and audit process.

Recommendation:

We understand the completion of the annual actuarial valuation report requires the third-party administrator to submit accurate member census data to ACTO in a timely manner as well as sufficient staffing resources by ACTO. We suggest that ACTO request that the third-party administrator submit the member census data in a time frame that allows ACTO sufficient time to review the data and prepare the report. If staffing constraints delay performing the valuation in a timely manner, we suggest that ACTO evaluate staffing needs and maintain sufficient personnel in order to complete the recommended procedures.

Fiscal Year 2015/2016 Observation #3 – Long-Term Care Fund Annual Actuarial Valuation (Continued)

Management Response:

The Actuarial Office and Benefits Programs Policy and Planning along with the Financial Office concur with this finding. We will work with the vendor in the next year to set up a process for timely delivery of the required data. This process will include time lines for when the data is needed, and procedures for delivering data and reports in a timely matter to complete the audit.

Fiscal Year 2016/2017 Status:

This recommendation was not implemented in fiscal year 2016/2017. In May 2017, during the planning stage of the fiscal year 2016/2017 audit, we met with appropriate personnel from ACTO and the Financial Office to determine the status of our recommendation and the timeline for completing the June 30, 2017 Long-Term Care Fund Actuarial Valuation. We were told that a draft valuation report along with the new experience study for the Long-Term Care Fund would be available by mid-September of 2017. ACTO later informed us that the June 30, 2017 valuation would not be available prior to the completion of our audit, and instead provided in mid-October a roll-forward of the June 30, 2016 Long-Term Care Fund actuarial valuation to June 30, 2017. A roll-forward is acceptable under generally accepted accounting principles and actuarial standards of practice. However, the Long-Term Care Fund actuarial information should be made available earlier to provide sufficient time for audit procedures.

Fiscal Year 2016/2017 Management Response:

ACTO has been hard pressed every year to complete the current year liabilities before the September 30 timeline. This year has been particularly difficult with the plan switching to a first principles model. Staffing will continue to be an issue in the foreseeable future. To mitigate this timeline stress, ACTO has proposed to switch to a roll forward of the previous year's liability number. This way, our methodology is more consistent with what we do on the pension side. Also, using a roll forward would be an easy way to get the liabilities we need well before the September 30th deadline. We have moved towards the roll forward methodology starting in the 2017 CAFR.

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.

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

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.

Fiscal Year 2015/2016 Status:

During the fiscal year 2015/2016 audit, we noted this recommendation is in process of being addressed.

Fiscal Year 2016/2017 Status:

The comment and recommendation related to the instances in which employers exist in my|CalPERS multiple times and have more than one my|CalPERS ID number is still in process of being addressed.

Fiscal Year 2016/2017 Management Response:

Management concurs with the recommendation. As part of the my|CalPERS Functional Optimization project, reports will be created in addition to workflow items that will initiate multiple program areas to identify, validate, and correct data issues and appointment data. The target date for implementation is June 30, 2018.