

Summary of Financial Statement Audit Management Letter Comments
Current Year Report
As of March 31, 2018

Audit Management Letter Comments for the Year Ended 06/30/17

Observation #1: Service Organization Control (SOC) Reports

Division responsible: Financial Office

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 1 (SOC 1) report. 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.

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.

Financial Office's Current Update: OPEN. Financial Reporting Accounting Services (FRAS) has established a team of managers and staff dedicated to managing the implementation of this observation recommendation. FRAS staff have reached out to various CalPERS program areas to identify vendors used that provide services that may have financial reporting impacts. Upon gaining a population of these vendors, FRAS is working with the program areas to obtain any available SOC 1 and SOC 2 reports for review. In the event a vendor does not furnish a SOC 1 or SOC 2 report, FRAS is receiving the vendor's audited financial statements (or related report) to provide assurance that the service organization's internal controls are effective. FRAS will continue working with program areas to obtain all relevant reports, and will begin reviewing these reports before year-end to identify any deficiencies in internal controls that may impact

CalPERS financial reporting. An annual process to determine any financial reporting impacts, based on third-party service providers' SOC-1 reports, will be in place by the July 31, 2018 target date.

Observation #2: Accounting and Reporting for OPEB Contributions and Reimbursements Outside of the California Employers' Retiree Benefit Trust Fund (CERBTF)

Division responsible: Financial Office

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.

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.

Financial Office's Current Update: OPEN. CERBT Management is currently working with the Office of Public Affairs on the webinars and has four tentative dates scheduled in May 2018.

CERBT Management is working on the PowerPoint Presentation and scripting for the Webinar to address year-end data collection as well as a renewal OPEB valuation documentation collection. In addition, CERBT Management and Team Members have revised all forms related to the renewal valuation collection and have emailed all CERBT contracted Employers, as well as external actuaries who may perform the OPEB valuations for CERBT contracted Employers. CERBT Management will be sending out email communication on a monthly basis to remind and assist in the data collection from the employers. CERBT Team Members are currently working on revisions to the year-end OPEB data summary collection form which will be rolled out to employers through the Webinars scheduled in May 2018. The corrective actions will be implemented by June 30, 2018.

Observation #3: Accounting and Reporting for the Replacement Benefit Fund (RBF)

Division responsible: Financial Office

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.

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.

Financial Office's Current Update: OPEN. FRAS continues to meet reconciliation due dates and has corrected financial misclassifications. The my|CalPERS system upgrades have improved data accuracy in RBF reconciliation report which has allowed for less reconciling items as well as more timely monthly reconciliations. The Pension Benefit Accounting team in FRAS continues frequent communication with IRC 415b Processing team in BNSD to ensure consistency between the general ledger and amounts outstanding and paid to the members recorded in my|CalPERS. FRAS is on target to meet implementation due date of July 31, 2018.