KPMG

California Public Employees' Retirement System

Report to the Risk and Audit Committee

Audit plan and strategy for the year ending June 30, 2018

June 20, 2018

Agenda

Client service team

Scope of services

Objectives of an audit

Responsibilities

Materiality in the context of an audit

Risk Assessment

KPMG's audit approach and methodology

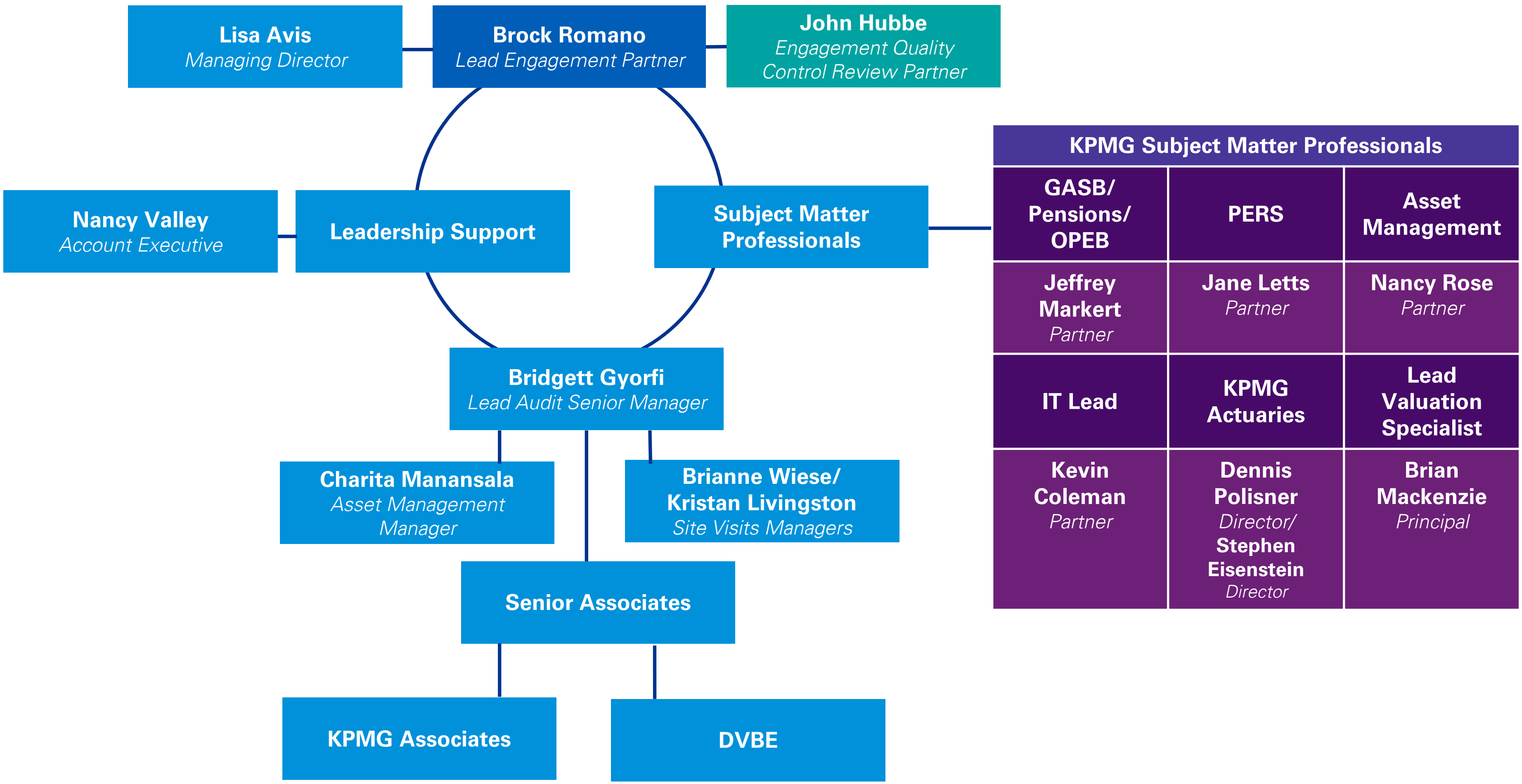
Focus areas

KPMG independence quality controls

Recent developments in accounting and financial reporting

KPMG's Audit Committee Institute (ACI)

Client service team



Scope of services

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- Audit of Comprehensive Annual Financial Report (CAFR) and GASB 68 and 75 Specified Elements

Deliverables

- Independent Auditors' Report on CAFR
- Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters (required under *Government Auditing Standards*)
- GASB 68 and 75 reports on Specified Elements
- Report to the Risk and Audit Committee (Required communications at the conclusion of the audit)
- Management comments and recommendation letter

Timeline

- Planning – ongoing
- Fieldwork – now through December 2018
- Final Financial Reporting - CAFR – October 31, 2018
- Issuance of the report - CAFR – November 2018
- GASB 68 and 75 reports – December 2018

Objectives of an audit

— The objective of an audit of the financial statements is to enable the auditor to express an opinion about whether the financial statements that have been prepared by management with the oversight of the Risk and Audit Committee are presented fairly, in all material respects, in conformity with generally accepted accounting principles in the United States of America (U.S. GAAP).

— We plan and perform the audit to obtain reasonable, rather than absolute, assurance about whether the financial statements taken as a whole are free from material misstatement, whether due to fraud or error.

— Our audit includes:

- Performing tests of the accounting records and such other procedures, as we consider necessary in the circumstances, based on our judgment, including the assessment of the risks of material misstatement, to provide a reasonable basis for our opinion.
- Evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, and evaluating the overall presentation of the financial statements.

— Audit performed in accordance with applicable audit standards:

- Generally Accepted Auditing Standards in the United States of America (U.S. GAAS)
- Government Auditing Standards (GAS)

Responsibilities

Management responsibilities – Financial statements	— Fairly presenting the financial statements, including disclosures in conformity with U.S. GAAP — Adjusting the financial statements to correct material misstatements and affirming in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole
Management responsibilities – ICOFR	— Design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
Management responsibilities – Other	— To provide the auditor with: (1) access to all information of which management is aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters; (2) additional information that the auditor may request from management for the purpose of the audit; and (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence — Identifying and ensuring that the entity complies with laws and regulations applicable to its activities, and for informing the auditor of any known material violations of such laws and regulations — Providing the auditor with a letter confirming certain representations made during the audit, that includes but is not limited to management's: (1) disclosure of all significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the entity's financial reporting (2) acknowledgement of their responsibility for the design and implementation, and maintenance of internal controls to prevent and detect fraud
Risk and Audit Committee responsibilities	— Oversight of the financial reporting process and ICOFR — Oversight of the establishment and maintenance by management of programs and controls designed to prevent, deter, and detect fraud
Management and the Risk and Audit Committee responsibilities	— Setting the proper tone and creating and maintaining a culture of honesty and high ethical standards — Ensuring that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in the entity's financial statements.

The audit does not relieve management or the Risk and Audit Committee of their responsibilities.

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Responsibilities (continued)

KPMG responsibilities – Audit	— Performing the audit in accordance with U.S. GAAS and GAS and that the audit is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements as a whole are free from material misstatement — Performing an audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting
KPMG responsibilities – Other information in documents containing financial statements	— The auditors' report on the financial statements does not extend to other information in documents containing audited financial statements, excluding required supplementary information — The auditor's responsibility is to make appropriate arrangements with management or the Risk and Audit Committee to obtain information prior to the report relevant date and to read the other information to identify material inconsistencies with the audited financial statements or misstatement of facts — Any material inconsistencies or misstatement of facts that are not resolved prior to the report release date, and that require revision of the other information, may result in KPMG modifying or withholding the auditors' report or withdrawing from the engagement — We have performed the following procedures with respect to other information: - Review for consistency with financial statements

Responsibilities (continued)

KPMG responsibilities – Communications	— Communicating significant matters related to the financial statement audit that are in our professional judgment, relevant to the responsibilities of the Risk and Audit Committee in overseeing the financial process. U.S. GAAS and GAS do not require us to design procedures for the purpose of identifying matters to communicate to the Risk and Audit Committee — Communicating if we suspect or identify noncompliance with laws and regulations exist, unless matters are clearly inconsequential — Communicating to management and the Risk and Audit Committee in writing all significant deficiencies and material weaknesses in internal control identified during the audit, including those that were remediated during the audit and reporting to management in writing all deficiencies noted during our audit that, in our professional judgment, are of sufficient importance to merit management's attention. The objective of our audit of the financial statements is not to report on the entity's internal control — Conducting the audit in accordance with professional standards and complying with the rules and responsibility of the Code of Professional Conduct of the American Institute of Certified Public Accountants and the official standards of relevant CPA Societies, and relevant state boards of accountancy — Communicating to the Risk and Audit Committee circumstances, if any, that affect the form and content of the auditors' report — Communicating if we plan to withdraw from the engagement and the reasons for the withdrawal — Communicating to the Risk and Audit Committee if we conclude no reasonable justification for a change to the audit engagement exists and we are not permitted by management to continue the original audit engagement — Communicating to the Board of Administration in writing any conclusion(s) that the Risk and Audit Committee's oversight of external financial reporting and internal control over financial reporting is ineffective — When applicable, we are also responsible for communicating particular matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement — Communicating if we have identified or suspect fraud involving; (a) management, (b) employees who have a significant role in internal control, (c) others, when the fraud results in a material misstatement in the financial statements, and (d) other matters related to fraud that are, in the auditors' professional judgment, relevant to the responsibilities of the Risk and Audit Committee — Communicating significant findings and issues arising during the audit in connection with the entity's related parties.

Materiality in the context of an Audit

We will apply materiality in the context of the preparation and fair presentation of the financial statements, considering the following factors:

Professional standards require that we exercise professional judgment when we consider materiality and its relationship with audit risk when determining the nature, timing, and extent of our audit procedures, and when evaluating the effect of misstatements.

Information is material if its misstatement or omission could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.

Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Judgments about the size of misstatements that will be considered material provide a basis for

a) Determining the nature and extent of risk assessment procedures;

b) Identifying and assessing the risks of material misstatement; and

c) Determining the nature, timing, and extent of further audit procedures.

Risk assessment

Based on our initial risk assessment procedures, the following are significant risks that may result in a material misstatement (due to fraud or error) in the financial statements.

Significant Risks:

— Risk of management override of controls – *Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk nevertheless is present in all entities.*

— Valuation of level 3 investments – *The level 3 investment portfolio is based on management's estimates and involves a high degree of judgment. The inherent risk is assessed as a significant risk*

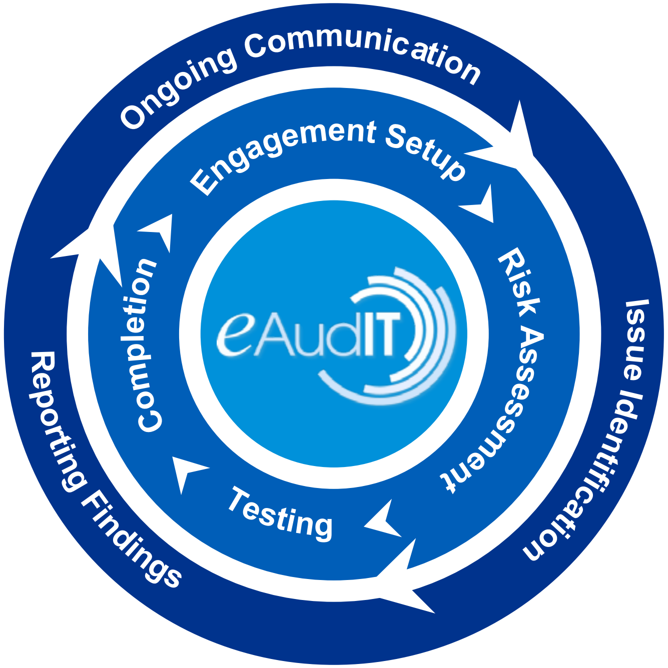
— Key actuarial assumptions– *The key actuarial assumptions are based on management's estimates and involves a high degree of judgment. The inherent risk is assessed as a significant risk.*

KPMG's audit approach and methodology

Technology enabled audit work flow

Engagement Setup
- Tailor the eAudIT work flow to your circumstances
- Access global knowledge specific to your industry
- Team selection and timetable

Completion
- Update risk assessment
- Perform overall evaluation of results and the financial statements
- Form and issue audit opinion on the financial statements
- Obtain written representations from management
- Required Risk and Audit Committee communications
- Debrief audit process



Risk Assessment
- Understand your business and financial processes
- Identify significant risks
- Plan involvement of specialists and others including experts, internal auditors, service organizations, and other auditors
- Determine audit approach
- Evaluate design and implementation of your internal controls

Testing
- Test effectiveness of internal controls, as applicable
- Perform substantive tests

Focus areas

Focus Area	Financial Line Item	Procedures

Investments	Investments
	Investment Income
		- Test account reconciliations
		- Confirm investments
		- Test valuation of non-alternative investments
		- For alternative investments:
		  - Evaluate management's process for valuing the investments
		  - Obtain audited financial statements where available
		  - For certain investments using latest valuation as of March 31, predict the likely change in value to June 30
		- Test investment income

Contributions	Retirement and OPEB Contributions	- Confirming employer and member contributions - Test a sample of contributions by recalculating based on the required contribution rates

Benefit Payments	Retirement, Death and Survivor Benefits	- Test a sample of benefit payments for the following:
		  - Completeness, existence, and accuracy and
		  - Paid in accordance with plan provisions
		  - Participant was eligible to receive the benefit

Focus areas (continued)

Focus Area	Financial Line Item	Procedures
Insurance Claims	Estimated Insurance Claims Due Claims Expense	- Test the key assumptions used in determining the insurance claims liability is properly recorded - Test a sample of insurance claims for completeness, existence, and accuracy
Premium Revenue	Premiums	- Test a sample of premium revenue for completeness, existence and accuracy
Actuarial Valuations - **Reasonableness of assumptions and methods** - **Completeness and accuracy of member census data**	Pension Liability OPEB Liability	- Test a sample of the census data to determine completeness and accuracy of the data - Evaluate the assumptions and methods in determining the post-retirement liabilities are properly recorded
Disclosures	Various	- Assess disclosures in accordance with U.S. GAAP

KPMG independence quality controls

KPMG maintains a comprehensive system of quality controls designed to maintain our independence

— Pre-approval of all worldwide engagements by the audit engagement team through Sentinel, a KPMG independence verification system

— Monitoring employment relationships

— Tracking partner rotation requirements using PRS, the firm's automated partner rotation tracking system

— Automated investment tracking system used by all KPMG member firms (KICS)

— Training and awareness programs

— Compliance testing programs

Independence

— In our professional judgment, we are independent with respect to the California Public Employees' Retirement System.

Recent developments in accounting and financial reporting

Effective Fiscal Year 2018:

— **GASB Statement No. 75: Accounting and Financial Reporting for Postemployement Benefits Other Than Pensions (OPEB)**

- Improves accounting and financial reporting by state and local governments for postemployment benefits other than pensions (other postemployment benefits or OPEB)
- Improves information provided by state and local governmental employers about financial support for OPEB that is provided by other entities

— **GASB Statement No. 81: Irrevocable Split-Interest Agreements**

- Establishes accounting and financial reporting standards for irrevocable split-interest agreements created through trusts where the donor irrevocably transfers resources to an intermediary

— **GASB Statement No. 85: Omnibus 2017**

- Clarified that certain money market investments and participating interest-earning investment contracts may be, but not required to be, measured at amortized cost
- Classification of employer-paid member contributions for OPEB

— **GASB Statement No. 86: Certain Debt Extinguishment Issue**

- Establishes accounting and financial reporting requirements for in-substance defeasance of debt using existing resources other than the proceeds of refunding debt

Recent developments in accounting and financial reporting (continued)

Effective Fiscal Year 2019:

— **GASB Statement No. 83: Certain Asset Retirement Obligations**

- Establishes accounting and financial reporting standards for certain asset retirement obligations

— **GASB Statement No. 88: Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements**

- Improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements

Effective Fiscal Year 2020:

— **GASB Statement No. 84: Fiduciary Activities**

- CalPERS has early adopted
- RBF – report as a Custodial Fund (new fund type)

Effective Fiscal Year 2021:

— **GASB Statement No. 87: Leases**

- Increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract

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KPMG's Audit Committee Institute (ACI)

In depth insights. In time to matter.

Audit Committee Institute Publications:

- Q1 2018 focus: Financial reporting and audit update

  Financial reporting and auditing update for audit committees and boards.

- Board's-eye view of data and analytics

  Given their oversight roles, how can boards and audit committees help ensure that the company is getting the appropriate insights from data and analytics while taking the necessary precautions to protect the company, its employees, customers, and others?

- Directors Quarterly: April 2018

  This edition of Directors Quarterly includes highlights from our annual conference and a financial reporting and auditing update, as well as considerations for virtual shareholder meetings, a look at how private company boards can approach sexual harassment risk, and a perspective on institutional investor expectations of corporate purpose.

Resources

— ACI Web site: www.kpmg-institutes.com/institutes/aci.html

— ACI mailbox: auditcommittee@kpmg.com

— ACI hotline: 1-877-KPMG-ACI

— Audit Committee Insights – U.S. and International editions (biweekly electronic publications): www.kpmginsights.com

— Government Institute Web site: http://www.kpmg-institutes.com/industries/government.html

Questions?

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