

November 16, 2018

The Board of Administration
California Public Employees' Retirement System
Sacramento, California

Ladies and Gentlemen:

We have audited the financial statements of the fiduciary activities and the proprietary activities of the California Public Employees' Retirement System (the System), a component unit of the State of California, as of and for the year ended June 30, 2018, and have issued our report thereon dated November 16, 2018. In planning and performing our audit of the financial statements of the System, we considered internal control over financial reporting (*internal control*) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements. The objective of our audit is to express opinions on the System's financial statements, in accordance auditing standards generally accepted in the United States of America (AICPA), but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

During our audit we noted certain matters related to internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are summarized on Appendix I.

The System's written responses to our comments and recommendations have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Our audit procedures are designed primarily to enable us to form opinions on the financial statements and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the System's organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This communication is intended solely for the information and use of management, the Board of Administration, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

[(signed) KPMG LLP]

Appendix I

Documentation of Non-GAAP Policies

Entities often determine that certain generally accepted accounting principles (GAAP) are not material and therefore excluded from presentation in their audited financial statements. The System has elected to also not reflect certain immaterial items from its Comprehensive Annual Financial Report (CAFR), for example certain cut-off reporting of accruals.

We recommend that the System formally document all of its non GAAP policies as well as annually evaluate and determine that said policies continue to be immaterial to its CAFR.

Management's Response

Management concurs with the recommendation. Management will work with staff to document all non-GAAP policies and procedures and put in place a systematic process for annual evaluation. Management will also put in place a procedure to evaluate changing or new pronouncements that occur during the year and how they would affect the policies.

Review of Third-Party Administrators

The System's proprietary funds include the activities of the Health Claims Fund (HCF) and the Long-Term Care Fund (LTCF) and the related oversight and monitoring of claims activity administered by third-party administrators (TPAs). During our audit, we noted that the System did not have access to nor routinely reviewed or reconciled the detail claims activity processed by the TPAs to what was reflected in the books and records of either the HCF or the LTCF.

We recommend that the System, review its oversight controls of the TPAs and update its controls as deemed necessary. At a minimum, we would recommend that the System reconcile summary TPA claim activity to the detail claim activity on a regular basis.

Management's Response

Management concurs with the recommendation. For the LTCF, CalPERS will implement controls to receive and reconcile the third party claims summary to the detailed records. For the HCF TPAs, CalPERS will expand the reconciliation of the claims summary to the detail claims through coordination with the State Controller's Office on a regular basis.

Actuarial Certifications

The System reports an incurred but not reported (IBNR) liability related to its HCF activity. The process for establishing the IBNR at year-end includes accumulating actuarial certifications provided by the various TPAs. While it's apparent that management monitors and reviews those TPA provided certifications, the System does not evidence that monitoring and review in a formal document or memorandum. Accordingly, we recommend that the System summarize the collected TPA certifications and have one of its health actuaries certify the year-end IBNR accrual in a formal document in accordance with the provisions Actuarial Standards of Practice No. 41, *Actuarial Communications*. Such a formal communication would clarify management's responsibility for the IBNR reported at year-end.

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Management's Response

Management concurs with the recommendation. Starting with the Fiscal Year 2018-19, CalPERS will standardize the process of collecting IBNR Actuarial Certifications from Third Party Administrators. CalPERS will also create formal documentation that summarizes and certifies the year-end IBNR estimates.

Accounting Position Statement

As evidence of a best practice approach to documenting key accounting decisions, the System prepares accounting position statements (APSs). We have reviewed several of these APSs during our initial audit this fiscal year. In an effort to improve the contents of these APSs, we have recommended some be updated to reflect current CAFR treatment (e.g. APS No. 2014/15-1 related to GASB 68 recognition on the CAFR) and/or suggested supplemental language (e.g. APS No. 2013/14-1 related to GASB 67 PERF breakout as PERF A, B and C). In other situations (e.g. APS No. 2015/16-1 related to GASB 68 NPL allocations to Public Agencies), we noted that certain APSs focused more on the conclusions reached than the process and laws and/or accounting literature considered in arriving at its conclusions.

We recommend that the System review its past APSs and update as deemed necessary. On a go-forward basis, we encourage the System to include a robust analysis of the laws and or accounting literature considered in arriving at and supporting its final conclusions.

Management's Response

Management concurs with the recommendation. Management will work with staff to create a process for evaluation of all accounting position statements each year. We will review for compliance with current accounting standards, applicable laws, regulations, pronouncements and other applicable governance. We will also make sure that any newly effective governance oversight items are put into practice and documented in the accounting position statements. Once position statements are updated and signed by management, a copy will be kept on file.

Census Data

The System is responsible for maintaining census data for the approximately 2 million members (active and retired) who participate in the System's defined benefit pension plans. Significant elements of census data include: date of birth; years of service; eligible compensation; and gender among other elements.

Effective management of the census data for active employees include procedures to verify the underlying payroll records of the participating employers to determine that the information provided is complete and accurate as this census information is utilized by the System's actuaries to calculate a total pension liability for each of the various defined benefit plans, a significant accounting estimate that is part of the financial reporting process.

In accordance with audit procedures promulgated by the American Institute of Certified Public Accountants (AICPA), we subjected certain Schools and Public Agencies whose employees are active members of the PERFs to census testwork that included comparing such information to the census file used by System. The results of our testwork indicated approximately 100 data quality issues such as incorrect date of birth, understated eligible compensation and/or incorrect years or service. Such data quality issues are not unusual for a public employee retirement system with nearly 1.3 million active members.

We understand that the System continually updates both the information technology and manual controls over its member management system, my/CalPERS. We recommend that the System conduct a root cause analysis for all its known errors and adjust its internal controls accordingly to address any common causes

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related to data errors. One potential common cause is the timeliness of data submitted through the my/CalPERS portal. Accordingly, we are also recommending that the System enhance its existing internal controls to ensure the timely and accurate reporting of census data by the participating employers.

Management's Response

CalPERS agrees the integrity of member data is critical to the administration of our system. We rely on our participating employers to supply timely and accurate member and payroll data to ensure appropriate benefits are paid to our participants. Our employers are extremely timely in submitting member demographic and payroll data on a consistent basis and we have system edits and audits to ensure accurate data on the front end and have appropriate consequences in place if the data is not accurate and timely. CalPERS is continually refining those edits and audits and developing additional controls where necessary. CalPERS recently conducted a review of over 2 million birthdates in our system, comparing them to social security records, and found an extremely low percentage of discrepancies and have taken actions to resolve those discrepancies. On an annual basis, the CalPERS actuaries perform reasonability checks on all member data and report any anomalies back to the program area to resolve. CalPERS will review the data quality issues identified to determine the nature of the issues and analyze if there are any root causes that can be addressed with system or internal controls.

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