Financial Statement Audit Management Letter Comments
Current Year Report
As Of March 31, 2012

Audit (Report Issue Date): Report to Management for the Year Ended 06/30/11 (12/2/11)	
Observation 2011-1:	**Significant Deficiency** - Executive Level Review of the Basic Financial Statements
Division responsible:	Fiscal Services Division

Observation:
We previously reported as observation #2 in fiscal year 2010 that the Fiscal Services Division did not have a process in place to ensure that CalPERS executives have an opportunity to review the draft financial statements prior to their issuance. In fiscal year 2011, CalPERS executives were given the opportunity to review the draft financial statements; however, the Fiscal Services Division did not provide sufficient time or attention to properly consider feedback resulting from the executives' review of the draft financial statements. A thorough review of the financial statements by executives in the Investment, Benefit, Health, Actuary, and Legal functions is a key component of internal control over financial reporting. During the fiscal year 2011 audit, those key officials were given a limited timeline to review the draft financial statements, and Fiscal Services had not sufficiently addressed the executives' inquiries and edits prior to the presentation of the financial statements to the Finance Committee. As a result, there were several revisions to the basic financial statements subsequent to the Finance Committee's approval. Although the changes were not material to the System as a whole, the additional audit procedures and related internal discussions caused delays in the completion of the audit and the issuance of the financial statements. An unreasonably limited timeline for executive manager review increases the risk that errors and inconsistencies in the financial statements will not be detected and corrected by Fiscal Services in a timely manner.

We recommend that Fiscal Services enhance the financial reporting process by incorporating sufficient time for executive management's review of the draft financial statements. The timeline for presenting the financial statements to the Finance Committee should be adjusted, if necessary, to ensure that all key managers and executives have sufficient time for review. Fiscal Services should properly investigate and resolve any inquiries or suggested revisions to the amounts and disclosures in the financial statements prior to the Finance Committee's approval.

Management's Response:
OPEN. The Fiscal Services Division concurs with the recommendations. It will re-evaluate the financial reporting process and the timeline, and will ensure that all key managers and executives have reasonable time for review and that their inquiries and suggested revisions are addressed timely. Fiscal Services Division expects to complete this item by October 2012.

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Preliminary Implementation Plan:
By June 30, 2012, Fiscal Services Division will take the following steps which will continue after June 30, 2012 since executive level review occurs primarily in October. Specifically, the Fiscal Services Division will:

- Meet with key managers and executives to discuss and evaluate timeline.
- Identify concerns from managers and executives to prepare for their review of CAFR documents.
- Promote efficiencies in the review process by identifying areas that can be reviewed in advance of previously established timelines.
- Prepare revisions to CAFR preparation timeline.
- Maintain effective communication with Fiscal division liaison to ensure issues are discussed and resolved throughout the process.

Observation 2011-2:	**Significant Deficiency** – Internal Controls Over Financial Reporting of Securities Lending Activities
Division responsible:	Fiscal Services Division

Observation:
During our testing of securities lending activities we identified several errors in the reported amounts and disclosures in the draft financial statements. Internal controls over the accounting and reporting of securities lending activities were not sufficient to prevent or detect and correct the errors in the draft financial statements.

1. **Unitization Impact on Securities Lending** - Securities lending activities in the unitized pools were not properly allocated to the individual funds participating in the pools. Rather, reinvested collateral, reinvestment earnings and collateral liabilities were reported in the Public Employees Retirement Fund (PERF). GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions* paragraph 9 states "If a government pools money from several funds for investment purposes and the pool, rather than the individual funds, has securities lending transactions, the government should report the assets and liabilities arising from the securities lending transactions in the balance sheets of the funds that have the risk of loss on the collateral assets. In many cases, this will involve a pro rata allocation to the various funds based on their equity in the pool." The Fiscal Services Division originally represented to us that the PERF bore the risk of loss for securities lending activities in unitized pools. Upon further discussion with Investment Office officials and General Counsel, it was determined that each participating fund bears the risk of loss on the collateral assets based on the proportionate share of unitized pool ownership. Consequently, management developed estimates of the securities lending collateral, reinvestment earnings and obligations that should have been allocated to the individual funds and concluded the misstatements were immaterial. The

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misstatements are summarized in Schedule I – Summary of Uncorrected Financial Statement Misstatements included in the report to the Finance Committee dated December 2, 2011.

2. **Improper Recording of Non-Cash Collateral** - During our testing of the securities lending activities we identified $222 million of non-cash collateral that was improperly recorded as both securities lending collateral and obligations. GASB Statement No. 28 paragraph 6 states "Securities received as collateral should be reported as assets if the governmental entity has the ability to pledge or sell them without a borrower default." Fiscal Services Division personnel recorded the non-cash collateral as assets even though the System did not have the ability to pledge or sell the non-cash collateral without a borrower default. An audit adjustment was subsequently posted to correct the original reported amounts.

3. **Inaccurate Disclosure of Securities Lending Collateral** - The GASB Statement No. 40 credit risk disclosures contained the following errors relating to securities lending collateral:

- Approximately $9 billion of repurchase agreements were improperly disclosed as having credit risk in the GASB Statement No. 40 disclosures.
- Approximately $1.3 billion of unrated short-term investment fund (STIF) holdings were disclosed as having AAA ratings.

The GASB staff Comprehensive Implementation Guide states "Repurchase agreements are not subject to credit risk disclosures if the securities underlying the repurchase agreement are exempt from credit risk disclosures." The securities underlying the repurchase agreements held as securities lending collateral were equity securities and therefore were not subject to the GASB Statement No. 40 credit risk disclosures. In addition, investments in unrated pools should be disclosed accordingly. The errors were corrected in the audited financial statements.

The Fiscal Services Division lacks proper oversight relating to the accounting and reporting of securities lending activities. Internal controls over financial reporting should be enhanced to ensure that securities lending activities are properly reported in accordance with generally accepted accounting principles. Fiscal Services Division management should identify the relevant accounting and financial reporting requirements and ensure that personnel responsible for the recording of securities lending activities have a sufficient understanding of the Securities Lending Program and the related accounting and financial reporting requirements.

Management's Response:
OPEN. The Fiscal Services Division concurs with the observation and recommendation. Fiscal Services will review the internal controls over the financial reporting process to ensure that securities lending activities are properly reported in accordance with generally accepted accounting

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principles. In addition, Fiscal Services will ensure that appropriate staff has a sufficient understanding of the Securities Lending Program and the accounting and financial reporting requirements. Fiscal Services Division expects to complete this item by December 2012.

Preliminary Implementation Plan:
Specifically, by June 30, 2012, Fiscal Services Division will:

- Work with the Investment Office to implement a process to ensure that securities lending income and expenses in the unitized pools are properly allocated to the individual funds participating in the pools.
- Work with State Street Bank and the Investment Office to implement a process to ensure that the reinvested collateral, reinvestment earnings and collateral liabilities as of June 30 are properly recorded in the individual funds participating in the pool.
- Ensure that staff has a thorough knowledge of both GASB Statement No. 28 and No. 40 to ensure the securities lending activities are properly reported in accordance with generally accepted accounting principles.

Observation 2011-3:	**Significant Deficiency** – Classification of Investment in Unitized Pools
Division responsible:	Fiscal Services Division

Observation:
During our testing of investment balances we noted that approximately $6.6 billion of securities held in unitized portfolios were improperly reclassified to reflect the underlying pool securities. CalPERS accounting policies and generally accepted accounting principles dictate that investments in unitized pools should be reported at net asset value based on the participating funds' ownership percentages and classified in the financial statements based on the designated or predominant asset class of the respective pool. It is not necessary or proper to look-through the pool to the underlying securities. During the fiscal year, the methodology to report the unitized portfolios was changed for the Public Employee Retirement Fund, which resulted in the erroneous reclassification and was derived manually using an Excel workbook with more than 20 worksheets of data and calculations. The change in methodology occurred without the proper review and approval of the appropriate level of management. The error was detected and corrected as a result of our audit procedures, which led to significant staff inefficiencies and delays in the audit process as a result of the necessary corrections to the master reconciliation, GASB 40 reconciliation and disclosures, and the financial statement classifications. We recommend that the Fiscal Services Division implement policies and procedures to require that any significant changes to financial accounting and reporting which would have a material impact on the System's financial statements be reviewed and

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approved by management personnel possessing appropriate technical knowledge to approve such changes. In addition, reporting responsibilities within the Financial Reporting Unit should be refined as necessary to ensure the accuracy and integrity of financial reporting.

Management's Response:
OPEN. The Fiscal Services Division concurs with the recommendation and will continue using the previously approved methodology for reporting unitized portfolios at net asset value. In addition, it will add language to its policies and procedures to require that any significant changes to financial accounting and reporting, which would have a material impact on the financial statements, be reviewed and approved by the appropriate management level. Furthermore, the Financial Reporting Unit will reevaluate reporting responsibilities within the unit and make any necessary changes to ensure the accuracy and integrity of financial reporting. Fiscal Services Division expects to complete this item by December 2012.

Preliminary Implementation Plan:
By June 30, 2012, Fiscal Services Division (Investment Accounting Unit) will continue to use the previously approved methodology for reporting unitized portfolios at net asset value in the financial statements. Specifically, Fiscal Service Division will:

- Continue to use the approved methodology for reporting unitized portfolios at net asset value.
- Enhance policies and procedures to require that any significant changes to financial accounting and reporting, which would have a material impact on the financial statements, be reviewed and approved by the appropriate management level.

Observation 2011-4:	**Significant Deficiency** – Accounting and Financial Reporting of New or Unique Transactions
Division responsible:	Fiscal Services Division

Observation:
We previously reported as observation #6 in fiscal year 2009 that the Fiscal Services Division lacked a formal process for identifying, documenting and ensuring proper accounting and reporting of new or unique transactions. In fiscal year 2011, we identified the following unique transactions that were not properly reported in the draft financial statements:

1. **Investment Portfolio Transfers** - During the fiscal year, an affiliate fund investment portfolio was closed and the net assets were transferred to a new portfolio. Both investment portfolios were part of the supplemental income plan

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unitization structure. The close-out and transfer of the net assets were erroneously recorded twice as the Fiscal Services Division accounted for the transfer as part of the monthly investment portfolio recording process and also as part of a non-routine journal entry. The error resulted in misstatements of employee contributions and net appreciation in fair value of investments of approximately $214 million in the IRC 457 fund which was corrected in the audited financial statements. Although the error was detected by our audit procedures and Fiscal Services personnel at the time of the audit, the lack of oversight and timely analysis increases the risk that material errors will occur and not be detected.

2. **Early Retiree Reinsurance Program (ERRP)** - The ERRP, authorized under the Patient Protection and Affordable Care Act of 2010, is a temporary reinsurance program for early retirees enrolled in employment-based health plans. In fiscal year 2011, the CalPERS Health Care Fund (HCF) received ERRP reimbursements in the amount of $42.5 million which were incorrectly classified as self-insurance premiums. Revenues should be classified in the financial statements based on the nature and source of the revenue. The Fiscal Services Division did not identify the ERRP reimbursements as a new and unique transaction and lacks a formal process to ensure the reimbursements were properly reported in the financial statements. An audit adjustment was posted to properly classify the reimbursements in the audited financial statements and new disclosures were added to describe the infrequent receipt.

We previously recommended that Fiscal Services formally document new and unique issues. We suggested the documentation include pertinent background information, relevant legal and/or accounting guidance and the conclusions reached. We also recommended that the documentation be prepared by staff with sufficient experience and reviewed by appropriate management personnel. In addition, Fiscal Services should devote attention to the various business activities at the enterprise-wide level to identify transactions which could have an impact on CalPERS' financial statements. This can be accomplished through attending monthly board and committee meetings, and through monthly or quarterly meetings with Division officials within the organization.

We further recommend that the Financial Reporting Unit review the individual fund financial statements on a periodic basis to identify significant and/or unusual differences between the amounts reported in the current and prior periods. Financial Reporting Unit personnel should work with the respective Divisions and Branches to gain an understanding of the significant or unusual differences, document the reasons for and nature of the differences, and evaluate whether the activity is properly recorded in the financial system. These additional procedures will help reduce staff and audit inefficiencies and ensure that transactions are properly and consistently reported in the financial statements.

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Management's Response:
OPEN. The Fiscal Services Division concurs with the recommendations. Taking all the recommendations into consideration, it will develop a process for identifying, documenting and ensuring proper accounting and reporting of new or unique transactions. Fiscal Services Division expects to complete this item by September 2012.

Preliminary Implementation Plan:
By June 30, 2012, Fiscal Services Division will take the following steps and continue these after June 30, 2012 since the financial reporting process including transaction analysis, continues past that date. Specifically, the Fiscal Services Division will:

- Inquire and identify any new events and programs, and unique transactions and business activities which could have an impact on CalPERS' financial statements by meeting with various divisions on a periodic, regular basis;
- Document new and unique transactions in issue memos which include pertinent background information, relevant legal and/or accounting guidance and the conclusions reached;
- Review the individual fund financial statements or trial balances on a periodic basis to identify significant and/or unusual differences between the amounts reported in the current and prior periods; and
- Work with various divisions to gain an understanding of the significant or unusual differences, document the reasons for and nature of the differences, and evaluate whether the activity is properly recorded in the financial system.

Observation 1:	Completeness and Accuracy of Investment Related Disclosures
Division responsible:	Fiscal Services Division

Observation:
The Fiscal Services Division lacks a formal process to validate investment disclosure data provided by the custodian bank to the related amounts reported in the general ledger and other supporting documentation, which increases the risk of errors in the financial statement disclosures.

We noted the following errors during our audit of the GASB Statement No. 40 investment risk disclosures:

1. The draft credit risk disclosure reflected that certain debt securities totaling approximately $1.9 billion were not rated. We verified using an independent source that the security was in fact rated with an AAA credit rating. The data feed

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provided by the custodian bank incorrectly characterized the security as having no credit rating, and the Financial Reporting Unit did not independently validate the data. The disclosure was subsequently revised to reflect the AAA credit rating.

2. The draft foreign currency risk disclosure misclassified international real estate investment trust securities (REITS) as equity securities. The custodian bank classifies REITS as equity investments. The Fiscal Services Division manually reclassified the REITS to real estate investments in the statement of fiduciary net assets, but failed to reclassify the REITS in the foreign currency risk disclosure. The disclosure was subsequently revised to accurately reflect the international REITS as real estate investments.

In addition, we observed the following during our audit of the GASB Statement No. 53 derivative disclosures:

1. The GASB Statement No. 53 workbook provided by the custodian bank did not contain maturity dates for individual derivative instruments subject to interest rate risk. Instead, the custodian provided the maturity dates in a summary schedule. The Fiscal Services Division prepared the note disclosures based on the summary data and did not reconcile the detailed schedule by individual derivative instruments to the disclosure summary schedule. In addition, the Fiscal Services Division did not validate the maturities of individual derivative instruments which increases the risk of errors in the disclosure.

2. The draft schedule of derivative instruments reflected notional dollar amounts for certain derivatives for which the underlying notional amount should have been in shares. The Fiscal Services division did not validate the data reported by the custodian bank which led to errors in the disclosure, which were corrected in the audited financial statements.

3. The written GASB Statement No. 53 review and validation process was not updated from the prior year and does not include instructions for the preparation and review of each table comprising the GASB 53 disclosures.

We recommend that the Fiscal Services Division reevaluate and refine current processes to ensure that investment disclosure data provided by the custodian bank is complete and accurate, which should include validating data on a sample basis using third-party vendor sources or obtaining supporting evidence from the custodian bank to validate the data.

Management's Response:
OPEN. The Fiscal Services Division concurs with the recommendation and will reevaluate and refine current processes to ensure that investment disclosure data provided by the custodian bank is complete and accurate.

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This will include validating data on a sample basis or by obtaining supporting evidence from the custodian bank. Fiscal Services Division expects to complete this item by December 2012.

Preliminary Implementation Plan:
By June 30, 2012, Fiscal Services Division (Investment Accounting Unit) will ensure the data provided by the custodian bank is validated and will reconcile by individual derivative instruments to the disclosure summary schedule and ensure it is in a consistent format for the financial statements. Specifically, Fiscal Services will take the following actions:

<u>GASB Statement No. 40</u>

- Procedures will be enhanced to include conducting a test of the Not Rated Securities listing.
- Procedures will be enhanced to report international REITS securities in the Real Estate Column.

<u>GASB Statement No. 53</u>

- Procedures will be enhanced to reconcile the individual derivative instrument to the summary and validating the maturity dates of the instruments.
- Procedures will be enhanced to confirm Notional Value and the number of shares are reported correctly.
- Procedures will be established for preparing the GASB 53 Table.

Observation 2:	Reconciliation of Benefit Payments
Division responsible:	Fiscal Services Division

Observation:
In fiscal year 2011, benefit payment reconciliations were not performed in a timely manner. The Retirement Information Benefit System (RIBS) is used to calculate retiree pension benefits and release warrants for payment. The Fiscal Services Division performs the benefit payment reconciliation by comparing the activity reflected in RIBS to the activity reported in the general ledger. The reconciliation is generally performed on a semi-annual basis; however, for fiscal year 2011 staff performed only one reconciliation, which was completed more than three months after the fiscal year end.

We recommend that the Fiscal Services Division perform periodic and timely reconciliations of benefit payment activity to ensure that amounts recorded in the general ledger are complete and accurate.

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Management's Response:
OPEN. The Fiscal Services Division concurs with the observation and recommendation. With the implementation of my|CalPERS, new processes are being developed to timely ensure benefit payment activity is accurately recorded in the general ledger. Fiscal Services Division expects to complete this item by June 2012.

Preliminary Implementation Plan:
By June 30, 2012, Fiscal Services Division will take the following steps:

Prior to the implementation of my|CalPERS in September 2011:

- Benefit payments were reconciled between the Retirement Information Benefit System (RIBS-legacy system) and Comprehensive Financial Report (CAFR) expenses.
- This process was performed on a semi-annual cycle as CAFR expenses through December 31st and June 30th were taken from the semi-annual flux analyses (Semi-annual analytical review) which were produced in April 2011 and September 2011, respectively.
- The timing of flux analyses was one of the reasons why reconciliations were never completed within 30 days of month-end.

The Fiscal Services Division will now:

1. Prepare the last legacy RIBS to PeopleSoft reconciliation. Continue the process of preparing the 12/31/2011 reconciliation and will complete it within 30 days of receiving the Flux analysis in April 2012. This will be a combination of converted legacy data and new my|CalPERS.

2. Validate that my|CalPERS transactions agree to amounts posted to PeopleSoft. This is currently done on a daily basis at the individual account level rather than the CAFR rollup.

3. Reconcile each of the individual accounts that make up the CAFR total on a monthly basis. This will ensure reconciliations are completed timely.

4. Provide the auditors a schedule that lists the individual accounts which will tie to the CAFR amount.

5. Provide cross-training of additional staff so that any future staff interruptions will not hinder our ability to perform the reconciliation in a timely manner.