

**CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM**

Management Comments and Recommendations

For the Year Ended June 30, 2012

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CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Comments and Recommendations

For the Year Ended June 30, 2012

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February 12, 2013

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 California Public Employees' Retirement System (the System or CalPERS) as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered CalPERS' internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion 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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. In addition, because of inherent limitations in internal control, including the possibility of management's override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies identified as items 2012-1, 2012-2, and 2012-3 in the Significant Deficiencies section of this report to be significant deficiencies. The status of the prior year significant deficiencies is included in the Status of Prior Year Significant Deficiencies section of this report.

In addition, in the current and prior fiscal years we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The current year comments are included in the Other Comments and Recommendations section of this report. The status of the prior year comments is included in the Status of Prior Years' Comments and Recommendations section of this report.

CalPERS' responses to the comments and recommendations are described in the Significant Deficiencies and Other Comments and Recommendations sections of this report. We did not audit the System's response and, accordingly, we express no opinion on it.

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
February 12, 2013

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Significant Deficiencies

For the Year Ended June 30, 2012

2012-1: Completeness and Accuracy of Investment Related Disclosures

We previously reported as observation #1 in fiscal year 2011 that the Fiscal Services Division lacks a formal process to verify that investment disclosure data provided by the custodian bank agrees with the related amounts reported in the general ledger and other supporting documentation. We noted several errors in the draft investment disclosures during the 2011 audit.

In fiscal year 2012, we noted the following errors during our audit of the Governmental Accounting Standards Board (GASB) Statement No. 40 investment risk disclosures:

1. Federal Home Loan Mortgage Corporation (FHLMC) securities were originally disclosed as not being subject to the GASB Statement No. 40 credit risk disclosure requirements. GASB Statement No. 40 specifically exempts from the credit risk disclosure requirements securities that are explicitly guaranteed by the U.S. government. The FHLMC securities are not explicitly guaranteed by the U.S. government and therefore are subject to the disclosure requirements. The disclosure was subsequently revised to properly reflect the GASB Statement No. 40 credit risk disclosure requirements for the FHLMC securities.
2. Short-Term Investment Fund (STIF) investments held in the System's unitized pool, which are classified as debt securities on the financial statements, were originally excluded from the GASB Statement No. 40 credit risk and interest rate risk disclosures. GASB Statement No. 40 specifically requires that credit risk and interest rate risk disclosures be presented for pooled investments such as STIF investments. The disclosure was subsequently revised and the required disclosures were made for the STIF investments.

In fiscal year 2012, we noted the following errors during our audit of the GASB Statement No. 53 derivative disclosures:

1. In three instances, the original disclosures improperly reflected fair values for derivative instruments that had no fair values at year-end. These errors were subsequently revised in the GASB Statement No. 53 derivative disclosures.
2. The draft disclosures included four instances in which the notional dollars for certain derivative instruments were originally reported in notional units, and two instances in which the derivative instruments were reported in notional dollars rather than in notional units. These errors were subsequently revised in the GASB Statement No. 53 derivative disclosures.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-1: Completeness and Accuracy of Investment Related Disclosures (Continued)

Given the complexity of the accounting standards and the System's investment transactions, we recommend that these disclosures be prepared and reviewed by personnel who possess proper technical knowledge of the accounting standards and comprehension of the System's investment structure and transactions. Furthermore, Investment Accounting personnel in the Fiscal Services Division should validate the completeness and accuracy of investment disclosure data provided by the custodian bank.

Management Response:

Fiscal Services Division concurs with the recommendation to validate the completeness and accuracy of investment disclosure data provided by the custodian bank with the preparation and review of disclosures by Fiscal Services staff with the necessary technical knowledge due to the complexity of the data. Fiscal Services Division will strengthen procedures to validate the completeness and accuracy of investment disclosure data provided by the custodian (State Street Bank). The Fiscal Services Division will work with State Street Bank to implement a Service Level Agreement to document roles and responsibilities to ensure complete and accurate information from State Street Bank. There will be a closer collaboration of Investment Office and Fiscal Services staff to share investment expertise that better supports the validation of the disclosure data provided by the custodian bank. In addition, Fiscal Services Division staff has implemented a secondary level of review by management and will revisit the current timelines to ensure we leave adequate time to perform our due diligence before the disclosures are submitted.

Fiscal Services Division continues to partner with State Street Bank in offering staff access to investment training courses and workshops in order to expand staff knowledge and expertise. As well, we have enrolled five of our staff in the INVO Smart Training program to enhance their technical knowledge through direct investment training. Fiscal Services anticipates the procedures and secondary level of review to be in place for the upcoming fiscal year-end close activities beginning July 1, 2013 and concluding in October 2013.

2012-2: Account Analysis and Financial Reporting

As part of our audit, we requested and the Fiscal Services Division provided comparative trial balances for all funds along with an analysis of significant or unusual changes in account balances and financial statement line items. We utilize the analysis to identify significant or unique transactions and to ensure that financial transactions are properly classified and recorded. The analysis should also support management's discussion and analysis in the financial statements. Based on our review of the analysis, we noted the following errors and opportunities for improvement:

- There were several general ledger accounts and financial statement line items with unexpected or unusual changes from the prior year that were not properly analyzed and resolved by Fiscal Services personnel. We determined that the changes were due to the improper posting of transactions to certain general ledger accounts, which resulted in audit adjustments.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-2: Account Analysis and Financial Reporting (Continued):

- The original account analysis and management's discussion and analysis (MD&A) in the financial statements both described the changes between current year and prior year balances in dollar amounts and percentages but did not provide the reasons for the changes. Determining the reasons for significant changes is essential for ensuring the proper classification and recording of financial transactions and complying with financial reporting requirements.

The account analysis and MD&A should include a discussion of the reasons for significant or unusual changes in financial position and results of operations in the current year compared to the prior year. We recommend that the Fiscal Services Division's review and analysis of the comparative trial balances include an investigation of significant changes in financial position and results of operations. The investigation should include inquiries of key personnel in other Divisions to ensure a proper understanding of current year financial transactions and activities. Although Fiscal Services Division is ultimately responsible for ensuring the completeness and accuracy of the financial statements, incorporating the unique perspectives of the personnel responsible for key activities would enhance the usefulness and improve users' understanding of the financial statements.

Management Response:

The Fiscal Services Division concurs with the observation and recommendation to:

- 1) perform in-depth analysis on general ledger accounts and financial statement line items with unexpected or unusual changes
- 2) investigate significant changes in financial position and results of operation to obtain appropriate information to determine reasons and for inclusion in the MD&A

The Fiscal Services Division will implement the recommended actions for the 2012/13 audit of the basic financial statements and note disclosures.

Preliminary Implementation Plan:

By June 30, 2013, the Fiscal Services Division will take the following steps to address the issue:

- 1) Meet with key managers of various accounting units and program areas to discuss the issue, potential solutions, and steps to resolve the issue.
- 2) For the management discussion and analysis, study the best practices by reviewing other pension funds' Comprehensive Annual Financial Reports (CAFR) and adopt them where appropriate and applicable.

The Fiscal Services Division will continue to work on account analysis in order to successfully and timely complete the CAFR by November 2013.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-3: Implementation of my|CalPERS

The Pension System Resumption (PSR) Project has been a very large endeavor for the past few years. In fiscal year 2012, the PSR project culminated with the implementation of the my|CalPERS system. The my|CalPERS system creates a “one-shop stop” for more than 50 legacy systems, and is used for Retirement Services, Benefit Services, Health Services, and Employer Payroll/Contribution Services. The implementation of my|CalPERS encompassed several go live dates for the different business areas and plans. As part of our audit, we reviewed the general and application controls of the my|CalPERS system, and, as appropriate, we performed tests of significant controls related to the major transaction streams. Our testing revealed the following:

- Manual overrides – All elements are editable in the system. Manual overrides are performed in the areas of benefit calculations, payroll adjustments, sick leave conversions, educational leave, and community property to name a few. In some instances, personnel do not rely on the new system calculations but rather utilize the legacy systems and manual spreadsheets to perform calculations and manually override the benefit amounts in the my|CalPERS system.
- System Access – my|CalPERS application authorization roles should be periodically reviewed. IT general controls should ensure that information is properly secured, application access is granted to only authorized personnel, and user accounts are managed to enforce a proper segregation of duties. While proper user account provisioning and password controls have been implemented in the new my|CalPERS environment, and user authorization roles have been created, procedures are not yet established to periodically review user accounts and their associated roles to ensure they are up to date and enforce a proper segregation of duties.
- my|CalPERS General Controls – IT general controls for systems acquisition, development and change management should ensure that system implementations maintain the integrity and completeness of the information as well as ensuring processing accuracy. While the vast majority of transactions are processing correctly in my|CalPERS, there are some errors in the areas of benefit payment processing in health benefit deductions, death benefits, and employer reporting. While management is confident that outstanding issues have been identified and are being addressed, the impact of the errors and effects on the financial information has not been quantified.
- Data Query and Reporting Knowledge Transfer – The PSR project included the utilization of numerous external consultants. To date, there has not been an adequate transfer of knowledge as CalPERS personnel rely heavily on the external consultants to query data and to generate certain reports from the my|CalPERS system.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-3: Implementation of my|CalPERS (Continued)

CalPERS should enhance the following processes and controls:

- a. Re-evaluate the data elements within my|CalPERS and reduce the reliance on manual overrides in the system, particularly the manual overrides that impact financial statement amounts. In the instances manual overrides are necessary, management should ensure that proper internal controls are in place for such manual overrides. Furthermore, personnel should discontinue the use of manual spreadsheets in calculating benefit payments and should refrain from manually overriding the benefits calculated by my|CalPERS.
- b. The appropriate business unit managers, working with the application managers, should develop procedures for the periodic review and testing of my|CalPERS user accounts and their authorization roles to ensure they are up to date and enforce a proper segregation of duties. Documentation of the reviews should be maintained to substantiate the review process and corrections made. User roles and access rights should be evaluated to ensure that the access granted is critical to the performance of the employees' duties.
- c. CalPERS Office of Audit Services should consider conducting a review to determine the possible quantity of transactions and dollar value of the outstanding processing issues that the my|CalPERS implementation team has identified. Based upon the dollar value of the processing issues, a determination should be made as to the resources to be dedicated to addressing the outstanding issues.
- d. Develop a transition plan and conduct appropriate training to educate CalPERS personnel on the my|CalPERS system's data query and reporting functions and capabilities.

Management Response:

- a. The Customer Services and Support (CSS) Branch concurs with the observation and recommendation. Since the new system has been implemented the total number of overrides has decreased significantly and occurs on only a small percentage of the total calculations performed. Some overrides will continue to be necessary due to employer reporting errors and data conversion gaps, to pay benefits accurately and timely. CSS will continue to evaluate the data elements within my|CalPERS in regards to performing necessary manual overrides and usage of manual spreadsheets in the calculation of benefit payments. CSS currently tracks, logs and documents each override.

Preliminary Implementation Plan:

- CSS will continue to reduce the reliance on manual overrides by implementing identified enhancements or correcting defects that lead to the use of manual overrides.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-3: Implementation of my|CalPERS (Continued)

Management Response (Continued):

- CSS will continue to reduce the usage of manual spreadsheets in calculating benefit payments as system enhancements and the correction of defects are applied.
 - CSS will continue to enhance procedures and processes on the proper use and approval process for utilizing overrides. The Customer Services and Support System continues to monitor and plans a milestone evaluation at June 30, 2013.
- b. CSS Branch concurs with the observation and recommendation and has developed a plan to ensure procedures for the review and testing of my|CalPERS user accounts and their authorization roles are up to date. CSS will document the reviews to substantiate the review process. CSS will evaluate user roles and access rights to ensure that the access granted is critical to the performance of the employees' duties.

Preliminary Implementation Plan:

CSS is coordinating a user access project team which includes representatives from the Enterprise Risk Management Division, Information Security Management Section and the Office of Audit Services. CSS expects to implement the already approved my|CalPERS user access project by June 30, 2013. Specifically, CSS and the project team will:

- Update and roll out Requester and Approver procedures.
- Develop and implement procedures to review, communicate, and revoke access for users who have not accessed the system in the last 90+ days.
- Identify and implement a new base group role that provides limited access to peripheral users. This will replace the current CalPERS Agent as the base role and will provide limited access to my|CalPERS data.
- Review existing group roles to determine appropriate permission sets that should be included for unit staff to perform responsibilities. This is designed to prevent the routine need for cross-divisional approvals for UARS requests (User Access Request System).
- Conduct a detailed review and analysis to identify and implement changes to group roles and permission sets at the UID (User Interface Design) level. This effort will better define the group roles and permission sets and limit access to only what is needed by the business area to perform their work. Once completed CSS will implement system changes needed to add, change or delete group roles and permission sets while updating the my|CalPERS Security Matrix.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2012-3: Implementation of my|CalPERS (Continued)

Management Response (Continued):

- Develop, document and implement a process for creating, modifying and deleting roles and permission sets.
- c. The Office of Audit Services (OFAS) agrees with the recommendation. In the time since the financial statement audit, management has made significant continued progress in the areas noted. OFAS has included in its audit plan, and will continue to include, areas impacted by my|CalPERS, and to the extent the issues identified by the my|CalPERS implementation team have not already been addressed, OFAS will include an assessment of the impact of unresolved errors on financial information. OFAS plans to complete such reviews in stages and address all areas noted by June 30, 2014.
- d. Specifically relating to the area of data reporting, as of January 31, 2013, the Information Technology Branch completed the planned knowledge transfer activities from external consultants to CalPERS staff. External consultants continue to 'work down' their queue of data requests to fulfill their contractual obligations. All new data requests are handled by CalPERS Data Reporting staff who continue to mature their workload capacity. Some new requests may be routed to external consultants, as appropriate, if they are part of their existing contractual obligations. Where applicable, additional knowledge transfer activities may be initiated when new needs arise, prior to the external consultants' departure. Information Technology Services Branch expects to complete this issue by June 30, 2014.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations
For the Year Ended June 30, 2012

Fiscal Year 2011/2012 Observation #1 – Investment Classification

Certain investment portfolios are unitized in order to commingle the investments of the various plans. The unitized portfolios are categorized based on the primary nature of the underlying securities (i.e. domestic or international fixed income, and domestic or international equity unitized portfolios). During our audit, we noted inconsistencies in the way in which the Public Employees' Retirement Fund (PERF) reported unitized pool investments compared to the way in which the affiliated funds reported those same investments. The PERF classified the domestic and international pool investments based on the pools' underlying securities. In contrast, the affiliated funds properly reported the investments based on the categorization of the unitized pools and did not look through the pool to the underlying securities to report the investments. The misclassification of underlying securities reported by the PERF was deemed insignificant to the System's financial statements, and such amounts were not adjusted in the financial statements.

Furthermore, CalPERS' financial statements include inflation asset investments, which are comprised of commodities and treasury inflation-protected securities (TIPS). During our audit, we noted inconsistencies in the way in which inflation asset investments were originally reported in the financial statements. The PERF reported commodities and TIPS as inflation asset investments, whereas the Legislators' Retirement Fund (LRF) and the Judges' Retirement Fund II (JRF II) reported commodities and TIPS as equity and debt securities, respectively. The financial statements were subsequently adjusted to consistently report commodities and TIPS as inflation asset investments for the LRF and JRF II.

We recommend that current accounting practices be evaluated to ensure that investment transactions are consistently and accurately reflected in CalPERS' financial statements in accordance with generally accepted accounting principles.

Management Response:

Fiscal Services Division concurs with the recommendation to ensure that investment transactions are consistently and accurately reflected in CalPERS' financial statements in accordance with generally accepted accounting principles. Trust Accounting I & II staff will work closely together to coordinate the reporting of unitized portfolios to ensure the underlying securities are reported accurately and consistently across program areas. A secondary level of management review will be put in place to provide oversight. Fiscal Services Division will adopt the enhanced approach immediately to support the next fiscal year-end reporting process. This process begins July 2013 and will conclude on October 2013 when the basic financial statements and note disclosures are substantially completed.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2011/2012 Observation #2 – Investment Commitment Disclosures

The Fiscal Services Division utilizes the investment commitment summary worksheet provided by the Investment Office to prepare the investment commitment disclosures in the financial statements. During our audit, we noted the following errors related to the disclosures of investment commitments:

- Corporate governance securities are invested in the form of a partnership structure and are reported as equity securities in the financial statements. We noted one instance in which the original commitment amount was decreased during the fiscal year; however, the adjustment was not reflected in the investment commitment summary worksheet and the draft commitment disclosure was incorrect, which was subsequently revised. In addition, the original corporate governance investment commitment summary worksheet reflected certain commitment amounts in Euros, which should have been converted to U.S. dollars for financial reporting purposes. The amount was subsequently corrected to reflect U.S. dollars for disclosure purposes.
- The System entered into year-to-year contracts with certain real estate partners, in which any commitments not funded during the year must be reevaluated and approved by appropriate CalPERS personnel in order for capital calls to be funded in future years. Due to the nature of these contracts, there are no unfunded commitments for these partners at year-end. The original disclosure of unfunded real estate commitments included expired commitments to partners with year-to-year contracts. The disclosure was subsequently revised to properly exclude these partners.

We recommend the following processes be performed to ensure proper reporting of investment commitment disclosures:

- The Fiscal Services Division and Investment Office should establish a process to ensure that changes in investment commitment amounts are properly captured and disclosed in the financial statements.
- The Fiscal Services Division should establish a process to identify each investment partner that domiciles in a foreign country and verify that the amount is properly reported in U.S. dollars. The process should include inquiries of Investment Office personnel and a comparison of reported amounts to the partners' records.
- The Fiscal Services Division should review the commitment summary worksheets for reasonableness by comparing the changes in total commitment and unfunded commitment amounts for the current and prior years. Unexpected or unusual changes should be investigated and resolved through inquiries of Investment Office personnel and review of the partners' records.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2011/2012 Observation #2 – Investment Commitment Disclosures (Continued)

- The Fiscal Services Division should obtain an understanding of the nature and structure of investment contracts to ensure that unfunded commitment disclosures reflect only those commitments for which CalPERS is obligated to fund the remaining commitment amounts.

Management Response:

Fiscal Services Division concurs with the recommendation to ensure proper reporting of investment commitment disclosures. Fiscal Services Division and the Investment Office will work together to implement the suggested recommendations for the next year-end close activities beginning July 1, 2013. The Investment Office will enhance processes by implementing the following steps:

- Gather the necessary data for unfunded liability and capital commitment amounts from Private Equity, Real Assets and Corporate Governance
- Ensure that changes in investment commitment amounts are properly captured and accurately recorded on the commitment summary worksheets
- Ensure all amounts are properly reported in U.S. dollars
- Perform high level reasonableness calculations of amounts compared to prior year numbers
- Prepare an aggregated level schedule that shows the changes from prior period
- Validate the final numbers with the appropriate asset classes and provide appropriate documentation as determined by Fiscal Services Division staff

Fiscal Services Division supports the Investment Office's proposed steps to strengthen and improve the investment commitment disclosures. This also provides Fiscal Services Division the oversight to ensure proper reporting of investment commitment disclosures. Fiscal Services Division will enhance their processes by implementing the following steps:

- Review details of the commitment summary worksheets received from the Investment Office and perform a variance analysis
- Follow up with the Investment Office staff on any unusual or unexpected changes and perform analysis and review

We anticipate the new processes to be implemented and in place for the upcoming fiscal year-end close activities, which will conclude in October 2013.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2011/2012 Observation #3 – Internal Controls Over Benefit Processing

CalPERS implemented the Pension System Resumption (PSR) Project or my|CalPERS system during fiscal year 2012. In testing the Public Employees' Retirement Fund (PERF) benefit payments originating from my|CalPERS, we noted two instances of incorrect pensionable salaries, one instance of incorrect service credit purchases, and one instance of an incorrect retirement factor. These errors resulted in incorrect retirement benefit amounts, which were subsequently corrected. The primary cause of the errors was the result of the implementation of my|CalPERS.

We recommend the responsible department strengthen internal controls over benefit processing and reevaluate current policies and procedures to ensure accurate data is used in calculating retirees' benefit amounts.

Management Response:

Customer Services and Support concurs with the findings. During the first year of my|CalPERS implementation, incorrect data elements were periodically identified through testing and manual validations and were subsequently corrected. Upon major system enhancements, testing and validation continues to occur to verify consistency and accuracy. Policies and procedures on testing and validation will continue to occur and progress will be evaluated by June 30, 2013.

Fiscal Year 2011/2012 Observation #4 – Self-Funded Healthcare Enrollment Reconciliation

We previously reported as observation #8 in fiscal year 2007 that the reconciliation of enrollment records between the third-party administrator and CalPERS' records for the Healthcare Fund (HCF) was not performed timely. Blue Cross is the third-party administrator of the self-funded PERS Care, PERS Choice, and PERS Select health plans. Blue Cross reconciles, on a monthly basis, enrollment records and the related premiums received from the State of California (State). During our testing of premium revenues for the HCF, we noted the monthly enrollment reconciliations were not completed in a timely manner. As of October 2012, the most recent reconciliation was for the month of October 2011.

We recommend that management establish procedures to ensure Blue Cross enrollment records are reconciled to CalPERS records in a timely manner, and that any discrepancies are investigated and resolved prior to the next billing cycle or within a reasonable timeframe.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Other Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2011/2012 Observation #4 – Self-Funded Healthcare Enrollment Reconciliation (Continued)

Management Response:

As a result of CalPERS Enterprise-wide systems automation project implemented in September 2011 (my|CalPERS), existing Premiums Reconciliation file formats and file transfer protocols changed. As a result, Anthem Blue Cross could not generate the Premiums Reconciliation report for more than one year. CalPERS and Anthem Blue Cross agreed to halt the my|CalPERS Premiums Reconciliation file transfer format and resume using the my|CalPERS enrollment file. CalPERS and Anthem Blue Cross have agreed the most prudent approach to corrective action is to perform an on-going reconciliation with the enrollment file, rather than use the Premiums Reconciliation file until the my|CalPERS Premiums Reconciliation interface is functional. Anthem Blue Cross will utilize a complete enrollment file and will provide CalPERS an enrollment discrepancy report. CalPERS and Anthem Blue Cross will then jointly work to address the enrollment discrepancies. CalPERS will meet with Anthem Blue Cross to work through the details of the reconciliation process. In addition, regular touch-point meetings with Anthem Blue Cross will continue to ensure this process continues to move forward. CalPERS has also assigned an individual to document this procedure.

It's important to note that the functionality in my|CalPERS has been designed to minimize enrollment discrepancies. For example, the functionality in my|CalPERS supports the cancellation for non-payment (i.e. no health deduction taken from pay warrant) for active employees. This reduces the likelihood of an individual obtaining services and not paying a premium.

Customer Services and Support Division concurs with the recommendation and will work closely with Anthem Blue Cross to develop the procedures by April 30, 2013 and will implement the reconciliation process by July 31, 2013.

Fiscal Year 2011/2012 Observation #5 – Access to Programs and Data

IT General Controls should ensure that data is appropriately secured so as to ensure the accuracy, integrity and completeness of the data. While CalPERS Information Security Office (ISOF) has implemented the Guardium SQL device to monitor database activity, independent testing of the device has not yet been performed. Independent testing can help ensure that the device is identifying all possible unauthorized database layer changes.

The ISOF should have periodic independent testing performed of the Guardium SQL device to ensure that it is detecting and reporting all suspicious database layer activity.

Management Response:

The Information Security Office (ISOF) concurs with this finding. The ISOF will have periodic independent testing of the Guardium SQL device performed to supplement our internal testing. This independent testing will provide additional assurance that the Guardium device is detecting and reporting all suspicious database layer activity. The first test will be conducted August 31, 2013 because a Guardium upgrade is planned for the current fiscal year. ISOF will retain documentation of the results of the testing. The Information Security Office expects to complete this item by August 31, 2013.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies
For the Year Ended June 30, 2012

2011-1: Executive Level Review of the Basic Financial Statements

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 Response:

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.

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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-1: Executive Level Review of the Basic Financial Statements (Continued)

Preliminary Implementation Plan (Continued):

- 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 that any issues are discussed and resolved throughout the process.

Fiscal Year 2011/2012 Status:

This recommendation is considered implemented as significant efforts were made to address this recommendation, and key division chiefs and executives reviewed the draft financial statements. We encourage Fiscal Services to continue this effort and continue to ensure that inquiries or suggested revisions in the draft financial statements resulting from key personnel reviews are addressed prior to the submission of the financial statements to the Risk and Audit Committee.

2011-2: Internal Controls over Financial Reporting of Securities Lending Activities

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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-2: Internal Controls over Financial Reporting of Securities Lending Activities
(Continued)

The 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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-2: Internal Controls over Financial Reporting of Securities Lending Activities (Continued)

Management Response:

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 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, the 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.

Fiscal Year 2011/2012 Status:

Based on the fiscal year 2012 audit results, this recommendation has been implemented.

2011-3: Classification of Investments in Unitized Pools

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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-3: Classification of Investments in Unitized Pools (Continued)

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 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 Response:

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.
- Fiscal Services Division will require program accounting areas, such as the Investment Accounting Unit, to prepare accounting treatment memos for any significant changes to financial accounting and reporting methodologies, which would have a material impact on the financial statements, and to submit to the Financial Reporting Unit. Accounting treatment memos must be evaluated and concurred by the Financial Reporting Unit and, when necessary, by the external auditor.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-3: Classification of Investments in Unitized Pools (Continued)

Fiscal Year 2011/2012 Status:

Based on the fiscal year 2012 audit results, this recommendation has been implemented. However, refer to Fiscal Year 2011/2012 Observation #1 for other matters related to the classification of unitized pool investments.

2011-4: Accounting and Financial Reporting of New or Unique Transactions

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 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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-4: Accounting and Financial Reporting of New or Unique Transactions (Continued)

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.

Management Response:

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

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Year Significant Deficiencies (Continued)
For the Year Ended June 30, 2012

2011-4: Accounting and Financial Reporting of New or Unique Transactions (Continued)

- 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.

Fiscal Year 2011/2012 Status:

Based on the fiscal year 2012 audit results, this recommendation has been implemented.

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CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Years Comments and Recommendations
For the Year Ended June 30, 2012

Fiscal Year 2010/2011 Observation #1 - Completeness and Accuracy of Investment Related Disclosures

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 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.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Years Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2010/2011 Observation #1 - Completeness and Accuracy of Investment Related Disclosures (Continued)

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 Response:

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. 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:

GASB Statement No. 40

- 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.

GASB Statement No. 53

- Procedures will be enhanced to reconcile the individual derivative instruments 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.

Fiscal Year 2011/2012 Status:

This recommendation has not been implemented. Refer to Significant Deficiency 2012-1 for our current year findings and recommendations.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Years Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2010/2011 Observation # 2 - Reconciliation of Benefit Payments

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.

Management Response:

The Fiscal Services Division concurs with the observation and recommendation. With the implementation of myCalPERS, 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 myCalPERS 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 myCalPERS.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
Status of Prior Years Comments and Recommendations (Continued)
For the Year Ended June 30, 2012

Fiscal Year 2010/2011 Observation # 2 - Reconciliation of Benefit Payments (Continued)

Preliminary Implementation Plan (Continued):

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.

Fiscal Year 2011/2012 Status:

During the fiscal year 2012 audit, there was only one reconciliation performed for benefit payments between the RIBS and the general ledger system for the periods of July through September 2011. The reconciliation was completed in May 2012. Also, in September 2011, CalPERS implemented the new Pension System Resumption (my|CalPERS) system, and we noted benefit payment reconciliations were not completed in a timely manner due to the introduction of the new system's functionalities and challenges in generating the appropriate reports from my|CalPERS to perform the reconciliations. Fiscal Services Division should continue to ascertain that timely benefit payment reconciliations are performed to ensure complete and accurate financial reporting.

Fiscal Year 2011/2012 Management Response:

The Fiscal Services Division concurs with the recommendation to perform periodic and timely reconciliations of benefit payment activity to ensure that amounts recorded in the general ledger (GL) are complete and accurate. The GL Account Receivable Metric (GLARM) Reports needed to complete the benefit payment reconciliations were not available at the time of required reconciliation due to delays in the implementation of the myCal|PERS system. Subsequently, we received the necessary GLARM Report, and implemented the recommendation in June 2012 as originally indicated. The GLARM report now provides information necessary to reconcile the financial activity generated in myCal|PERS and sent to PeopleSoft. We are now able to perform timely benefit payment reconciliations to ensure the amounts recorded in the general ledger are complete and accurate and will continue to do so in the future.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals

Properties held in separate account real estate partnerships are valued based on third-party appraisals directed by the System. Appraised values are adjusted by the general partner to reflect changes in fair value between the appraisal date and the end of the System's financial reporting period. The System's real estate Performance Monitoring Unit (PMU) is responsible for ensuring appraised property values are properly recorded by the partnerships in accordance with the System's Investment Policy for Real Estate Accounting. During our testing of real estate partnership investments, we noted the following:

- The PMU faces significant challenges in performing the task of verifying that appraised values are being properly reflected in the partnerships' financial statements in a timely manner as there were approximately 1,600 individual properties appraised in fiscal year 2008-09 and only one staff was assigned to perform this function.
- Certain general partners report to the System at the aggregate or fund level rather than the individual property level. In some instances, it was difficult to verify that the appraised values were reflected by the partnerships as the property-level financial information is not provided by all general partners.
- Appraisals are completed throughout the fiscal year; however, there is no process in place to evaluate the changes in fair value from the appraisal date to the System's fiscal year-end.

The System should enhance the current processes by employing the following recommendations:

1. Assign the appropriate number of personnel to verify that appraised property values are recorded by the partnerships.
2. Require separate account general partners to provide financial information at the underlying property level to facilitate the appraisal verification process.
3. For separate account real estate partnerships that were not appraised as of the System's fiscal year-end, review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

Management Response:

The Investment Office (INVO) concurs with the MGO recommendations and will enhance the following current processes by June 30, 2012:

1. At this point, INVO has not requested additional positions to verify the appraised property values recorded by the partnerships in their quarterly financial statements. INVO will examine its current staffing to determine if positions could be redirected from other INVO functions to perform this role.
2. The new Automated Real Estate Information System (AREIS) will provide the structure for reporting the financial information at the underlying property level. The System is currently in its final stage of implementation. Real Estate general partners should have the ability to report at the property level starting with the 2010-11 Fiscal Year.
3. The INVO, Operations, Performance and Technology Division has recently instituted a new process where they now value CalPERS interests (required by the Appraisal of CalPERS Interests Policy) no more than five (5) months prior to June 30 of every year. This allows for no appraisal value of CalPERS interests to be more than 5 months old when provided as part of the year-end financials.

Fiscal Year 2009/2010 Status:

1. Although one staff continued to perform the function of verifying that appraised values are properly reflected in the partnerships' financial statements, the number of properties verified at the time of the audit has significantly increased compared to fiscal year 2008-09. CalPERS personnel discussed, with the respective partners, the reasons for variances between appraised values and the partnerships' financial statements, however, we noted CalPERS currently does not have a formal documented policy for following up with the partners in addressing and resolving variances. We recommend that INVO enhance this process by establishing a threshold for investigating variances between the appraisals and partnerships' financial statements. Any variances meeting the threshold should be investigated, resolved and documented in the reconciliation.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

2. In fiscal year 2009-10, AREIS was not fully implemented and this recommendation is anticipated to be implemented in fiscal year 2010-11. As AREIS is fully implemented in the future, CalPERS should enhance the following processes:
 - a. Ensure real estate partners provide financial information at the underlying property level for all partnerships in which CalPERS holds a majority effective ownership interest.
 - b. Establish a process to specify the responsible party who will be inputting CalPERS' effective ownership percentage within AREIS.
 - c. Because INVO personnel utilize CalPERS' effective ownership percentage from AREIS in verifying that the appraised values are properly reflected in the partnerships' financial statements; CalPERS' effective ownership percentage should be validated by appropriate personnel who possess sufficient knowledge of the partnership agreement and structure. Furthermore, CalPERS' effective ownership percentage should be periodically reviewed and updated by appropriate personnel.
3. For properties that were not appraised as of CalPERS' June 30th fiscal year-end, INVO should continue to evaluate whether significant changes in fair value between the most recent appraisal and the partners' June 30th financial statements are reasonable given known facts and conditions such as the real estate industry and market conditions. CalPERS should also develop a formal documented process including a tolerance threshold for evaluating changes in fair value. This process should be performed for real estate partnerships in which CalPERS holds a majority effective ownership interest.

Fiscal Year 2009/2010 Management Response:

INVO concurs with the recommendations and will enhance the following processes with target completion date on June 30, 2012:

1. INVO - Operations, Performance and Technology Division (OPTD) - Performance Monitoring Unit (PMU) shall expand the current documented procedures for the reconciliation process of appraised values to include a threshold for investigating variances between the appraisals and partnerships financial statements. The process will provide detailed guidelines to determine if the variance should be investigated, resolved and documented.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

2. INVO will enhance the following processes:
 - a) AREIS provides the structure for reporting financial information at the underlying property level. Although the Real Estate general partners have the ability to report at the property level, not all partners are contractually required to do so. INVO will include provisions in all new majority-interest partnerships formed, to include a requirement to provide property level financial statements when it is in the best interest of the fund. In addition, INVO will work with its current majority-interest partnerships to request that they provide property level financial statements when it is in the best interest of the fund.
 - b) INVO shall establish a process to specify the responsible party for providing CalPERS effective ownership percentage within AREIS.
 - c) INVO shall establish a process to ensure the CalPERS effective ownership percentage is validated by appropriate personnel and is periodically reviewed and updated by appropriate personnel.
3. INVO-OPTD-PMU shall develop a formal documented process to review the fair values contained in the financial statements on fiscal year end June 30th. The process shall include a risk tolerance threshold for evaluating any change in fair value since the last appraisal. The process should be performed for real estate partnerships in which CalPERS holds a majority effective ownership interest.

Fiscal Year 2010/2011 Status:

1. This recommendation has been implemented.
2. The following is the current year status for the recommended processes:
 - a. Financial information is provided by all Real Estate Investment Partners directly into the AREIS system. For Partnerships in which CalPERS holds a majority effective ownership interest, the financial information provided includes property level market valuations. Typically, property level valuations are contained within the statement of "Portfolio Market and Cost Values" or the "Portfolio Market and Book Values". In a few instances, the property level valuations are provided in other areas of financial information of the Quarterly Management Report (QMR). The property level valuation information provided by partners provides the necessary financial information to facilitate the appraisal reconciliation process. This recommendation is considered implemented.

Fiscal Year 2008/2009 Observation #4 - Real Estate Appraisals (Continued)

- b. When a Real Estate Partnership is created in the AREIS system, the Real Estate Unit ensures CalPERS' Partnership ownership percentage is correctly entered into AREIS. If CalPERS' Partnership ownership percentage changes, the Portfolio Analytics, Research and Operations (PARO) Unit will work with the appropriate Portfolio Manager in CalPERS Real Estate Unit (REU) to establish the correct ownership percentage and will then input the information into AREIS. The PARO Unit will draft formal written processes.
 - c. The PARO Unit will input the information into AREIS and will work with the appropriate Portfolio Manager in CalPERS REU to verify the effective ownership percentage.
3. The Performance Monitoring Unit will develop a process for reviewing partnerships' June 30 financial information to ensure significant changes in fair value are properly reported.

Fiscal Year 2011/2012 Status:

During fiscal year 2012, all recommendations have been implemented with the exception of the development of a formal process for reviewing partnerships' June 30 financial information to ensure significant changes in fair value are properly reported. The formal process will be completed in fiscal year 2013.