CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Management Letter

Fiscal Year Ended June 30, 2016

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________, 2016

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 fiduciary activities and the proprietary activities of the California Public Employees' Retirement System (the System or CalPERS)) as of and for the fiscal year ended June 30, 2016, 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 audit procedures that are appropriate in the circumstances for the purpose of expressing opinions 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.

However, during our audit we became aware of deficiencies in internal control other than significant deficiencies and material weaknesses and matters that are opportunities for strengthening internal controls and operating efficiency. The current year comments and recommendations are included in the Current Year Comments and Recommendations section of this letter. The status of the prior year's comments and recommendations is included in the Prior Year Comments and Recommendations section of this letter.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and suggestions with appropriate CalPERS personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

CalPERS' written responses to the current and prior years' comments and recommendations have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

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

California Public Employees' Retirement System
Management Letter
Current Year Comments and Recommendations
Fiscal Year Ended June 30, 2016

Fiscal Year 2015/2016 Observation #1 – Accounting and Reporting for Internal Pooled Investments

CalPERS implemented Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application* in fiscal year 2015/2016, which establishes general principles for measuring fair value and standards of accounting and financial reporting for assets and liabilities measured at fair value. As part of the implementation, the underlying securities held in CalPERS' internally pooled (unitized) investments are reported at fair value rather than at net asset value (NAV). We observed that unitized investments provided by the custodian bank are first recorded at NAV and then allocated to participating funds based on the respective fund's ownership percentage of the unitized portfolios. The Financial Office has to manually adjust the reported NAV in order to properly record the investment fair values and the related investment receivables and payables. The manual process is time consuming and prone to errors as the draft financial statements contained a misclassification between global debt securities and global equity securities, which was corrected in the audited financial statements.

Recommendation:

To enhance the current process, we recommend that the Financial Office work with the custodian bank to automate the accounting and recording for unitized investments.

Management Response:

The Financial Office concurs with this finding and has initiated a project with State Street Bank, our custodian, to automate the accounting and recording of the unitized investments. We are in the early stages of development and will have a working model by the end of December 2017. We have also started a project to enhance our current process, using macros and other automation tools to reduce the manual nature of the process and lower our risk of error. We will use this process in parallel with the automated tool.

Fiscal Year 2015/2016 Observation #2 – Replacement Benefit Fund Account Reconciliation

The Replacement Benefit Fund (RBF) was established to account for benefit payments to retirees whose retirement allowance exceeds the Internal Revenue Code (IRC) Section 415(b) limits. IRC Section 415(b) imposes a dollar limit on the annual retirement benefits an individual may receive from a qualified defined benefit pension plan. Employers are responsible for paying the excess benefit amounts for their former employees, CalPERS sends invoices to the respective employers for the portion of pension benefits exceeding the limits. Upon receiving payments from the employers, CalPERS remits the excess benefit portion to the respective retirees. The accounting and reporting for these types of transactions are custodial in nature and CalPERS reports a statement of net position for the RBF. As part of the fiscal year 2015/2016 financial statement audit, we obtained the year-end reconciliation between the general ledger and my|CalPERS for the receivable from employers and payable to members and employers accounts. We noted the balances do not reconcile and that as part of the annual reconciliation process, the data in the reconciliation generated from my|CalPERS has to be manually adjusted.

Recommendation:

We recommend that the Financial Office should work with the appropriate CalPERS Division to ensure that data in the general ledger and my|CalPERS are consistent and the two systems properly reconcile.

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Fiscal Year 2015/2016 Observation #2 – Replacement Benefit Fund Account Reconciliation (Continued)

Management Response:

The Financial Office concurs with this finding. The Financial Office currently reconciles the fund on a monthly basis to the receivable and payable general ledger account balances. We have identified and documented the discrepancies with the my|CalPERS report used for reconciliation and the data is in the process of being corrected. We are currently in development of a multi-phase system functional optimization scheduled early next year which will improve the overall data accuracy.

Fiscal Year 2015/2016 Observation #3 – Long-Term Care Fund Annual Actuarial Valuation

On an annual basis, an actuarial valuation report is completed to determine the Estimated Liability for Future Policy Benefits for the Long-Term Care Fund. In fiscal year 2015/2016, the Actuarial Office (ACTO) prepared the annual actuarial valuation report (the report) based on member census data provided by the third-party administrator. The Financial Office utilizes the report to record the Estimated Liability for Future Policy Benefits in the Long-Term Care Fund and for financial statement disclosure purposes. The Estimated Liability for Future Policy Benefits is considered a significant estimate in the Long-Term Care Fund due to the sensitivity of the underlying actuarial assumptions and methods. The fiscal year 2015/2016 draft valuation results were available in mid-October, which created a challenge in meeting the established financial reporting and audit timeline of October 31st. In order to meet this deadline, the valuation should be completed no later than September 30th to allow sufficient time to complete the financial reporting and audit process.

Recommendation:

We understand the completion of the annual actuarial valuation report requires the third-party administrator to submit accurate member census data to ACTO in a timely manner as well as sufficient staffing resources by ACTO. We suggest that ACTO request that the third-party administrator submit the member census data in a time frame that allows ACTO sufficient time to review the data and prepare the report. If staffing constraints delay performing the valuation in a timely manner, we suggest that ACTO evaluate staffing needs and maintain sufficient personnel in order to complete the recommended procedures.

Management Response:

The Actuarial Office and Benefits Programs Policy and Planning along with the Financial Office concur with this finding. We will work with the vendor in the next year to set up a process for timely delivery of the required data. This process will include time lines for when the data is needed, and procedures for delivering data and reports in a timely matter to complete the audit.

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Fiscal Year 2014/2015 Observation #1 – Investment Valuation

As part of our audit, we consider the appropriateness of the accounting methods used for measurement and disclosure of investments, which includes understanding the process used by management in developing fair value estimates and the controls related to those estimates. During our audit of investment fair values, we noted the following items:

a. We selected a sample of real asset appraisals completed by external appraisal firms in order to verify that the appraised real asset property value is properly reflected in the partnership's financial statements, which are used by CalPERS to report the fair value of real asset investments. As part of the reconciliation process, the Investment Portfolio Analytics (IPA) Unit within the CalPERS Investment Office (INVO) is responsible for verifying that the partnership reflects the appraised value in their financial statements. Our testing revealed the following items:

   1. The IPA Unit was unable to reconcile the appraised value of certain selected investments to the partnerships' financial statements due to complexities in the ownership structure of the funds. The IPA Unit provided information regarding the unreconciled investments to the respective CalPERS Portfolio Manager (PM) and requested the PM to follow-up with the general partners. However, the IPA Unit does not have a formal process to ensure that the unreconciled investments are addressed and resolutions are documented.

   2. The IPA unit utilizes a third-party consultant, Altus, to compile the results of the appraisals for comparison to the partnerships' financial statements. Part of the IPA Unit's process related to the appraisal reconciliation is to select a sample of appraisals to verify that the correct values are utilized by Altus. We noted that Altus erroneously entered the appraised value for one of the selected properties in Australian Dollars as opposed to U.S. Dollars. The IPA Unit compared the appraised value in Australian Dollars to the value reported in the partnership's financial statements presented in U.S. Dollars as the investment in question was not part of the IPA Unit's verification selections.

b. CalPERS holds certain securities that cannot be priced by the custodian bank primarily due to unique private investment structures and stale pricing. The respective Asset Class Unit within INVO is responsible for evaluating the investments and obtaining the most recent available pricing from other external pricing vendors. As part of the investment fair value testing, we examined a sample of these investments to ensure that the fair values recorded in CalPERS' financial statements are reasonable based on management's determination of fair value. Although we did not note errors for the selected transactions, we noted that there were investments with stale pricing dating from 2011 and one investment which was last priced in 1970. INVO currently has stale price procedures, and the established procedures are operating as designed. However, INVO should establish procedures with specific guidelines pertaining to the write-off of securities that have not been priced for a prolonged period of time. In addition, INVO should reevaluate and revise the established guidelines on an annual basis, as appropriate to ensure proper reporting of fair value as of CalPERS' fiscal year-end.

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Fiscal Year 2014/2015 Observation #1 – Investment Valuation (Continued)

c. CalPERS reports private equity investment fair values based on the partnerships' March 31st financial information adjusted for cash flow activities from April through June. Certain private equity partnerships are publically traded, and CalPERS values these investments based on the number of shares owned and pricing available as of March 31st. Public company investments should be valued based on the shares and pricing data as of June 30th for financial reporting purposes as that information is available during the financial statement closing process.

Recommendation:

As a result of investments being one of the most significant areas in CalPERS' basic financial statements, and there is a risk of material misstatement related to investment fair values, the Financial Office (FINO) should work with INVO to re-evaluate the current processes and procedures related to reconciliations and the determination of fair value of certain investment transactions for accounting and financial reporting purposes. In February 2015, the GASB issued Statement No. 72, *Fair Value Measurement and Application* (Statement). The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015. This Statement addresses accounting and financial reporting issues related to fair value measurements. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. The requirements of this Statement will enhance comparability of financial statements among governments by requiring measurement of certain assets and liabilities at fair value using a consistent and more detailed definition of fair value and accepted valuation techniques. This Statement also will enhance fair value application guidance and related disclosures in order to provide information to financial statement users about the impact of fair value measurements on a government's financial position. FINO should work with the custodian bank and INVO to evaluate CalPERS' investments and determine the proper applicability of the requirements of this Statement.

Management Response:

a. The investments in question represent non-controlling interests in joint venture structures held in one of CalPERS' separate accounts. IPA is updating its valuation procedures to clarify that for non-control positions, the partner is responsible for providing valuations under an approved policy. IPA will no longer be requesting appraisals for such investments as part of standard process. This information will be reviewed to ensure appraisal information is represented at fair value, by October 31, 2016.

   IPA has revised its appraisal review procedures to include an explicit check on currency reporting, even in cases where the variance falls below flagging thresholds. In addition, IPA is following up with Altus to ensure appropriate quality control procedures for appraisal data entry are in place, by October 31, 2016.

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<u>Fiscal Year 2014/2015 Observation #1 – Investment Valuation (Continued)</u>

Management Response (Continued):

b. With the implementation of GASB Statement No. 72, we will be evaluating our policy and procedures related to stale pricing. The policy will be reviewed to ensure prices are evaluated on a regular basis to ensure securities are written off timely. By June 30, 2016, the procedures will be reviewed and updated, as necessary, to ensure prices reflect fair value at the fiscal year-end.

c. With the implementation of GASB Statement No. 72, the Financial Office will develop procedures to evaluate private companies that become public and determine the accounting treatment of these transactions.

Fiscal Year 2015/2016 Status:

During the fiscal year 2015/2016 audit, we noted these observations were addressed. As such, we consider this recommendation to be implemented.

<u>Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures</u>

Total and unfunded commitments related to investments in limited partnership structures are disclosed in CalPERS' basic financial statements. As part of the audit, we selected a sample of transactions and performed various audit procedures and noted discrepancies as follows:

a. The draft note disclosure included total commitments for real asset and private equity partnerships that did not have any outstanding unfunded commitment balances. Once all commitments have been funded, the original total commitment should be removed from the disclosure.

b. The draft note disclosure included total commitments for private equity partnerships that became publically traded. As a result of being publicly traded, there are no outstanding unfunded commitments for these entities as they are no longer structured as limited partnerships.

c. For real asset investments, FINO relies on the information generated from the Automated Real Estate Information System (AREIS) for the total and unfunded commitment disclosure. Total and unfunded commitments within AREIS are based on the transactions posted by the general partners. We noted the following:

    1. The general partners erroneously entered two distributions in AREIS, which resulted in the misstatements in the total unfunded amount. Based on discussion with INVO personnel, there is no process in place to reconcile the total and unfunded commitment balances reported in AREIS to the general partners' capital account statements.

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Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures (Continued)

2. The total unfunded commitment amount for one partnership was incorrectly reflected in AREIS due to a time lag in the posting of capital contributions made on June 30, 2015. The unfunded commitment balance per the general partner's confirmation reply was less than the amount reported in AREIS as there were four capital call transactions remitted to the general partner, which were not reflected in AREIS as of June 30, 2015.

3. The total commitment reflected in AREIS should include all projects committed by CalPERS. For one partnership, the total capital commitments reported in AREIS reflected only the partnership's specific projects that were outstanding or in progress at year-end and excluded amounts related to completed projects.

d. For private equity investments, FINO relies on the information provided by the Private Edge Group for the total and unfunded commitment disclosure. We noted the following:

1. The total commitment for one investment partner was overstated as the original commitment amount was reduced as agreed upon by CalPERS and the general partner, and the reduced commitment was not reflected in the detail provided by the Private Edge Group and the original note disclosure.

2. For one partnership, the unfunded commitment amount reported by the Private Edge Group differed from the amount confirmed by the general partner due to a clerical error.

3. The total commitment disclosure improperly included three transactions, which relate to non-discretionary custom accounts. For non-discretionary custom accounts, CalPERS has discretion over the amount to be funded, despite the initial total commitment. As such, these amounts do not represent contractual obligations and should not be included in the note disclosure.

Recommendation:

FINO should review each partnership with total and unfunded commitment disclosures and evaluate the nature of the transactions to determine whether the disclosures are accurate. In addition, FINO should implement a verification process to agree the total and unfunded commitment amounts from AREIS and the Private Edge Group reports to the partnerships' records (i.e. capital account statements) on a sample basis, at a minimum.

Management Response:

Management concurs with the recommendation. By October 31, 2016, the Financial Office will document accounting treatment to better define the disclosure information, which will provide clarity to the process. The Financial Office will work with the Investment Office to develop procedures to produce and verify the information.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
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Fiscal Year 2014/2015 Observation #2 – Investment Commitment Disclosures (Continued)

Fiscal Year 2015/2016 Status:

During the fiscal year 2015/2016 audit, we noted these observations were addressed. As such, we consider this recommendation to be implemented.

Fiscal Year 2014/2015 Observation #3 – my|CalPERS Functionality

As part of our testing of employer contributions, we noted instances of employers with active members (also known as Active Appointments) that did not report any active member payroll during the fiscal year. One of the reasons was due to employers ending their contract with CalPERS or rolling into another division organization ID number; however, the employer did not separate the underlying active members. There were also instances in which employers exist in my|CalPERS multiple times and have more than one my|CalPERS ID number.

Recommendation:

The resolution of this observation requires a coordinated effort between the various divisions within CalPERS in conjunction with working with the affected employers. CalPERS should establish a plan to address these issues in order to increase data integrity within my|CalPERS.

Management Response:

Management concurs with the recommendation. As part of the my|CalPERS Functional Optimization project, we will be creating reports for employers that identify the data issues, specifically the appointment data for them to correct. The target date for implementation is December 31, 2016.

Fiscal Year 2015/2016 Status:

During the fiscal year 2015/2016 audit, we noted this recommendation is in process of being addressed.