

Summary of Financial Statement Audit Management Letter Comments
Current Year Report
As of September 30, 2018

Audit Management Letter Comments for the Year Ended 06/30/17

Observation #1: Service Organization Control (SOC) Reports

Division responsible: Financial Office

CalPERS engages service organizations to process and account for transactions that are significant to the administration and financial reporting of CalPERS investment, pension, health and long-term care activities. Statements on Standards for Attestation Engagements (SSAE) No. 16, Reporting on Controls at a Service Organization, and AICPA AT-C Section 320, Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting, which is effective for reports dated on or after May 1, 2017, provide guidance regarding examinations and related reports on controls at service organizations. One of the most effective ways a service organization can communicate information about the service organization and its control environment is through a Service Organization Control 1 (SOC 1) report. SOC 1 Type 2 report focuses on controls at the service organization that would be useful to user entities' internal control over financial reporting and includes an examination report on management's description of the suitability of the design and the operating effectiveness of the controls. CalPERS, as a user entity, requests SOC 1 Type 2 reports from certain third-party service organizations on an annual basis. However, CalPERS does not have processes or procedures in place related to the following:

- Identification of all third-party service providers that have a direct impact on CalPERS' accounting and financial reporting,
- Tracking of timely receipt and review of SOC 1 Type 2 reports,
- Review and evaluation of SOC 1 Type 2 reports to determine whether findings noted could have a direct impact on CalPERS' financial reporting, and
- Determination of whether CalPERS has the required complimentary user entity controls in place and whether those controls are operating effectively.

CalPERS should implement formal procedures related to the identification, receipt, and review of SOC 1 Type 2 reports for third-party service organizations that have a direct impact on CalPERS' financial statements. In addition, the Financial Office should review each SOC 1 Type 2 report along with the provisions of AT-C 320 to understand the scope and objectives of SOC 1 Type 2 engagements and to evaluate whether CalPERS' user entity controls are sufficient to compliment service organization controls.

Financial Office's Current Update: RESOLVED. Pending review of the financial statement auditor. SOC report process has now been established and implemented as of July 31st. Going forward, SOC reports will be reviewed on an annual basis, and recurring deviations with a material financial statement impact will be highlighted, as well as escalated to relevant users to be further researched. FRAS' role in the process will primarily relate to tracking and managing the SOC reports, coordinating with application users to confirm checks or reviews are in place. We consider this issue now closed.

Observation #2: Accounting and Reporting for OPEB Contributions and Reimbursements Outside of the California Employers' Retiree Benefit Trust Fund (CERBTf)

Division responsible: Financial Office

Governmental Accounting Standards Board (GASB) Statement No. 74, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, requires an Other Postemployment Benefits (OPEB) plan to report on all activities of the OPEB plan, and not solely the activities of the trust through which the OPEB plan is administered. Further, GASB Statement No. 74 requires that contributions from employers include amounts for OPEB as the benefits come due, including amounts that will not be reimbursed to the employers using OPEB plan assets. In addition, benefit payments should include benefit amounts paid directly by employers. In this circumstance, an amount equal to the benefit payments is recognized both as an addition to and a deduction from OPEB plan fiduciary net position. The System records this type of activity as Employer Contributions Outside of Trust – OPEB and OPEB Reimbursements – Outside Trust in the CERBTf statement of changes in fiduciary net position. In order to quantify benefits paid by employers outside of the trust, CERBTf Program personnel obtain this information from participating employers as part of year-end closing procedures. Contributions and reimbursements made outside of the trust are calculated as the sum of retiree healthcare premiums and implicit rate subsidies, net of any reimbursements made directly from the trust. As part of our testing, we noted the following errors, which resulted in audit adjustments:

- For 15 employers, there were errors in the implicit rate subsidy used in the calculations.
- For 10 employers, late and/or revised information submitted by the employers was not sufficiently reviewed for accuracy prior to making changes to the employers' original calculations.
- For three employers, calculations related to reimbursement amounts contained arithmetic errors.
- For two employers, the implicit rate subsidy was accounted for twice in the calculation.
- For two employers, the implicit rate subsidy used in the calculation pertained to an incorrect period.
- For one employer, CalPERS remitted an OPEB reimbursement that exceeded the employer's retiree healthcare premiums.

CERBTf Program personnel working in conjunction with the Financial Office should strengthen the current procedures to ensure the completeness and accuracy of information submitted by employers. Since the accounting and financial reporting for contributions and OPEB reimbursements outside of the trust is dependent on the completeness and accuracy of information submitted by the participating employers, management should consider providing additional guidance and tools to employers to assist in the preparation of financial information required by CalPERS.

Financial Office's Current Update: RESOLVED. Pending review by the financial statement auditor. CERBT delivered 4 Webinars in May 2018, with approximately 300 contracted employers in attendance. The Webinars were successful for the first year. CERBT revised the Fiscal Year End (FYE) Data Reporting Form to minimize/simplify the data required to be submitted by the employers to CERBT. Communication was sent to all contracted Employers in May and June regarding the renewal valuation package submission and FYE Data Reporting Form. CERBT has implemented a peer review process for all data entry of the OPEB Valuation

documents to improve data accuracy. We have implemented our plan to address the issue and we consider this item closed.

Observation #3: Accounting and Reporting for the Replacement Benefit Fund (RBF)

Division responsible: Financial Office

CalPERS elected to early adopt the provisions of GASB Statement No. 84, Fiduciary Activities, effective July 1, 2016. GASB Statement No. 84 eliminates the agency fund type and creates a new fund type called a custodial fund. As a result of the implementation, the RBF is now classified as a custodial fund and is required to present a statement of changes in fiduciary net position. During the audit, we noted the following items:

- The trial balance and reconciliations for the material RBF financial statement line items were not available for audit until mid-October.
- The original draft RBF financial statements contained misclassifications, which resulted in audit adjustments.
- Differences related to unearned replacement benefits recorded in the general ledger and my|CalPERS have not been corrected.

Although the Financial Office has improved reconciliation procedures, additional procedures are necessary to ensure RBF balances are complete and accurate.

The Financial Office should continue to work with the appropriate CalPERS Division to reconcile account balances in the RBF and to ensure accuracy and consistency between the general ledger and my|CalPERS. In addition, the information for the RBF should be made available by early September to allow sufficient time for auditing procedures.

Financial Office's Current Update: RESOLVED. Pending review by the financial statement auditor. In FY17/18 FRAS Pension Benefit team has updated procedures to prevent misclassifications of financial data and provide additional detail to reconcile between my|CalPERS and the general ledger. The team cleared reconciling items related to the unearned replacement benefits account. The Pension team worked with the BNSD IRC 415 Processing team to ensure my|CalPERS benefit payments adjustments are made in my|CalPERS and not outside the system which eliminated reconciling items between my|CalPERS and the financial general ledger. The team worked with IT developers to enhance the RBF Detail reconciliation report to ensure accuracy which eliminated most reconciling items between my|CalPERS and the general ledger. The updated procedures, agreements with BNSD, and enhancements to my|CalPERS reports has ensured the Pension Benefits team is able to complete reconciliations accurately and timely. This issue is now closed.