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MARSHALL SCHOOL OF BUSINESS

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Assemblyman Keith Richman, M.D.
State Capitol
Room 5128
Sacramento, CA 94814

Dear Assemblyman Richman:

You have requested that I provide comments about the desirability of requiring performance audits of California Public Employees Retirement System (CALPERS). I understand that such audits would be directed toward determining whether CALPERS, in preparing its financial reports in conformity with GAAP, uses best estimates of specific actuarial assumptions in measuring actuarial obligations and adequacy of funding, determining the effects of using any alternative assumptions on the aforementioned measurements, and evaluating whether bias may have affected the selection of such assumptions and related financial reporting results. My response is informed by publicly available CALPERS documents, telephone discussions with a number of individuals including representatives of CALPERS[1], and my knowledge and experience of auditing, financial accounting and reporting for employee benefit plans. I am also aware of publicity that has focused on relatively large and apparently unfunded obligations of state and local government entities for defined benefit pension and other defined benefit post retirement plans such as those related to health care. My response to your inquiry is based solely on my individual view[2] of what is in the public interest.

I understand that CALPERS currently undergoes several types of audits. One such audit is the annual financial statement audit conducted by independent Certified Public Accountants (CPA) and performed in accordance with Generally Accepted Auditing Standards (GAAS) and Government Auditing Standards (GAS).[3] Audits conducted in accordance with the aforementioned professional standards provide a number of important assurances; however, such assurances generally do not extend to the actuarial related matters described above.[4]

I am aware that CALPERS maintains an internal audit function that also provides important assurances. I further understand, however, that the internal audit function does not focus on actuarial assumptions or funding policies and I recognize that unless certain criteria are met, such governmental auditors do not possess the independence necessary for performing

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[1] CALPERS personnel with whom I discussed these matters include Messrs. Larry Jensen, Chief Auditor; Ron Seeling, Chief Actuary; Ken Marzian, Assistant Executive Officer; and Robert Benson, Audit Manager. I understand that these CALPERS individuals do not share my conclusions expressed herein.

[2] I currently serve the University of Southern California (USC) as the Ernst & Young Professor of Accounting in the Marshall School of Business and as a board member of the Governmental Accounting Standards Board (GASB). The positions expressed herein are my individual views and do not represent those of USC or GASB.

[3] I understand that CALPERS is not required to obtain audits in conformity with GAS; however, elects to do so.

[4] See, for example: GASB Statements of Governmental Accounting and Financial Reporting Standards No. 27, *Accounting for Defined Benefit Pensions Plans and Note Disclosures for Defined Contribution Plans*, Par. 10 and 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* , Par. 34.

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independent audits in accordance with GAAS.[5] Independence is, in my view, an exceptionally important attribute facilitating external reliance on audit results.

Finally, I understand that CALPERS generally obtains an actuarial valuation every three years that is performed by EFI Actuaries, an independent firm of actuaries. That valuation results in certifications that the "liabilities and costs computed by the AESD (Actuarial and Employers Services Division) staff … are accurate and computed in accordance with generally accepted actuarial principles"[6] for state plans and schools. I understand that EFI compares the actuarial assumptions and funding policies used by CALPERS with ranges of acceptable practices, however, they do not assess the preferability of specific actuarial assumptions used, determine the effect of using any alternative assumptions on the measurement of resulting obligations and funding adequacy, or evaluate whether bias may have affected the selection of such assumptions. Consequently, they do not report on those matters.

Based on my conversations with CALPERS personnel, I understand that the process for adopting actuarial assumptions requires that proposed changes be brought before the CALPERS Board in public meetings for adoption. Further, I understand that the U. S. Department of Health and Human Services also performs certain audits of CALPERS activities. While I certainly acknowledge the value of such processes I also understand that the processes, while providing assurances that the aggregate actuarial assumptions are considered reasonable, do not provide independent assurance that the specific actuarial methods used represent the best actuarial assumptions in specific circumstances.

Given the sensitivity of actuarial obligations and funding adequacy measures to variations in actuarial assumptions and the subjectivity and ambiguity of many of the actuarial assumptions required to perform actuarial studies, the absence of such assurances is, in my view, of concern. I, therefore, support a requirement to require performance audits designed to provide the aforementioned assurances and that the related amounts reported by CALPERS in conformity with GAAP are objective and unbiased.

If you have other questions about these matters I will, of course, be pleased to discuss them with you.

Sincerely,

William W. Holder

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[5] See: American Institute of Certified Public Accountants (AICPA) Professional Standards, Vol. 2: ET ¶ 101 and 92.03.
[6] EFI Actuaries, "Parallel Valuation and Certification of the Actuarial Valuations of the CALPERS State and Schools Plans as of June 30, 2003", March 15, 2005.