To the Public Employees Retirement Board of the
Oregon Public Employees Retirement System
Tigard, Oregon

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

We have audited the basic financial statements of the Oregon Public Employees Retirement System (the System), as of and for the year ended June 30, 2011, and have issued our report thereon dated December 29, 2011. Our report contained explanatory paragraphs describing the System's actuarial funded status for the pension and other postemployment healthcare benefit plans as of December 31, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the System is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the System's internal control over financial reporting 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 the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and recommendations, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies 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 a 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 consider the deficiency described as item 2011-1 in the accompanying schedule of findings and recommendations to be a material weakness.

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 described as items 2011-2 and 2011-3 in the accompanying schedule of findings and recommendations to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the System in a separate letter dated December 29, 2011.

The System's responses to the findings identified in our audit are described in the accompanying schedule of findings and recommendations. We did not audit the System's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the Public Employees Retirement Board, and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & O'Connell LLP

Sacramento, California
December 29, 2011

OREGON PUBLIC EMPLOYEES RETIREMENT SYSTEM
Schedule of Findings and Recommendations
Material Weakness
For the Year Ended June 30, 2011

2011-1 - INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE – STANDARD RETIREE HEALTH INSURANCE ACCOUNT

Oregon Revised Statutes section 238 allows the System to enter into contracts for health care coverage for the System's retirees and their dependents. The retirees pay for this coverage. The System created the Standard Retiree Health Insurance Account (SRHIA) to account for certain healthcare activities associated with the program. As the administrator of the healthcare program, the system establishes premium rates, manages enrollment, and engages a third-party administrator to coordinate the payment of retiree health premiums. The System originally reported the accumulation of the retirees' share of health premiums and the subsequent payment of those amounts to the third party administrator in a separate employee benefit trust fund. In a coordinated effort between our audit procedures and the detailed research and review by management, at June 30, 2011 we ascertained that the SRHIA fund was improperly reported as an employee benefit trust fund due to an incorrect interpretation of accounting and financial reporting standards. The June 30, 2011 financial statements were revised to present the SRHIA fund as an enterprise fund in accordance with generally accepted accounting principles. In addition, we determined that the System had excluded from its financial records approximately $80 million of cash on deposit with the health carrier along with the estimated liabilities for claim payments and other program revenues and expenses. A lack of program oversight led to these material omissions in the System's financial records and resulted in prior period adjustments in the SRHIA trust fund and SRHIA proprietary fund of approximately $8 million and $62 million, respectively.

The System has not established internal controls or evaluated the related third-party administrator's internal controls over the processing and recording of SRHIA fund transactions, which is a critical component of plan administration and financial reporting. Without such controls there is a risk that amounts reported in the System's financial statement are not complete or accurate. Furthermore, there is a risk that the SRHIA fund's activities do not comply with plan or legal provisions and financial reporting requirements.

Management Response:

The reporting for the PERS SRHIA fund has been a complex matter. PERS sought advice from the Governmental Accounting Standards Board (GASB), which was followed for years and passed several financial audits without concern. Based on the modified guidance secured during this audit, we will now report this fund as described above. Additionally, PERS Internal Auditors are conducting a review of the Health Insurance Program. To address the concerns over third-party administrator controls, we will be requiring a report on controls in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 16, which has superseded SAS 70. This requirement will be included in the new contract for third party administrator services.

Expected Completion Date: December 31, 2013

2011-2 INTERNAL CONTROL OVER FINANCIAL REPORTING - NEW ACCOUNTING GUIDANCE

During our audit, we identified to-be-announced securities and related investment payables totaling approximately $1.3 billion that were not properly recorded. In 2011, Governmental Accounting Standards Board staff provided additional guidance to account for and to report the purchase of certain U.S. government debt securities that do not yet exist—"when-issued" and "to-be-announced" securities. The System's current accounting practices do not prescribe specific procedures to identify, research and document unique transactions and new accounting issues. As a result, the securities were not properly recorded, which resulted in inefficiencies in the audit process and material adjustments to the financial statements.

We recommend the System establish a process for identifying and properly accounting for new or unique transactions. The process should include formal documentation of the issue, pertinent background information, relevant legal and/or accounting guidance and the conclusions reached. The documentation should be prepared by personnel with sufficient experience and reviewed by appropriate management personnel. Formal documentation will reduce staff and audit inefficiencies and ensure that transactions are properly and consistently reported in the financial statements.

Management Response:

PERS has contacted the Oregon State Treasury (OST) and found that they initiated a project in 2011 to redesign financial reporting processes to standardize the work they perform to ensure that investment balances and financial disclosures are fairly presented to the Oregon Public Employees Retirement Fund (OPERF) in conformity with generally accepted accounting principles. This redesign includes the development of a formal process for the implementation of new GASB guidance, as this area was targeted for improvement during project planning.

OST expects to make significant progress toward project goals during calendar year 2012, with the ultimate goal of fully implementing a new financial reporting process for fiscal year 2013 reporting.

Expected Completion Date: June 30, 2013

Internally, PERS will establish a formal process to identify, research, and document unique transactions and new accounting issues. The process will include:

- Reviewing all new standards issued by GASB and determining their applicability to the System;
- Coordinating the timing of implementing new rules and standards with the Department of Administrative Services Statewide Accounting and Reporting Section and the Oregon State Treasury;
- Assuring appropriate staff attend annual GFOA GAAP update training sessions;
- Reviewing mid-year implementation guide supplements on GASB's website;
- Reviewing comprehensive implementation guides provided by GASB.

Expected Completion Date: June 30, 2012

OREGON PUBLIC EMPLOYEES RETIREMENT SYSTEM
Schedule of Findings and Recommendations (Continued)
Significant Deficiencies
For the Year Ended June 30, 2011

2011-3 INTERNAL CONTROL OVER FINANCIAL REPORTING – ACCOUNT RECONCILIATION

In the course of completing the audit, we noted the following issues related to financial statement account reconciliations:

- Reconciliation of Investment Balances - By law, the responsibility for the investment function is delegated to the Oregon Office of State Treasury (OST). We noted a lack of reconciliations between OST, the custodian bank, external investment managers and the investment consultant's records for private equity, real estate, and opportunity investment asset classes for the quarter ended June 30th. OST performs reconciliations for the 3rd quarter ended March 31st adjusted for cash flow transactions through June 30th. However, for the last quarter of the fiscal year, OST relies on the information provided by the investment consultants and does not perform independent reconciliations to verify whether the balances reported by the consultants are complete and accurate.

- Reconciliation of Unfunded Commitments – Currently OST relies on the consultants and there is no formal oversight of the consultants' work related to unfunded commitments for private equity, real estate and opportunity investments. The unfunded commitment amounts disclosed in the System's financial statements are derived directly from the investment consultant's quarterly report. We noted discrepancies between amounts reported in the investment consultant's report and the amounts confirmed by the investment managers. The discrepancies were subsequently corrected and unfunded commitment amounts were properly disclosed in the System's financial statements.

- Year-End Investment Summary and Reconciliation – As part of the year-end closing process, OST prepares an annual investment summary and reconciliation worksheet using the data obtained from the custodian bank. The annual investment summary and reconciliation worksheet is prepared by OST accounting personnel; however we noted that it is not reviewed or approved by personnel independent of the preparation function.

- Reconciliation of Real Estate Appraisals – Wholly owned real estate properties are valued based on third-party appraisals directed by OST. 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. Currently, there is no formal process to ensure that the appraised market values are accurately reflected in the general partner's financial information. In addition, 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.

- Reconciliation to Third-Party Administrator's Records - On a monthly basis, accounting personnel perform monthly reconciliations between amounts reported in the System's general ledger and the amounts reported by the third-party administrator for the Oregon Public Service Retirement Plan Individual Account Program. We noted unexplained differences in the monthly reconciliation that have been carried forward since 2006. The unresolved variance totals approximately $12.9 million and impacts several financial statement line items (i.e. contributions, investment net income, and benefit payments).

OREGON PUBLIC EMPLOYEES RETIREMENT SYSTEM
Schedule of Findings and Recommendations (Continued)
Significant Deficiencies
For the Year Ended June 30, 2011

- Reconciliation to Subledgers - We discovered that formal reconciliations were not completed between the System's general ledger and the subledgers (RIMS and jClarety) for contributions and benefit payments. Reconciliations between the general ledger and the subledgers are a key component of internal control over financial reporting and help to ensure that contributions and benefit payments are properly recorded.

Accounting tasks such as monthly reconciliations play a key role in proving the accuracy of accounting data and information included in the financial statements. Therefore, we suggest that management employ the following processes:

- Establish more effective review and reconciliation policies and procedures as a customary part of the accounting process.

- Perform monthly or quarterly reconciliations between OST, the custodian bank, external investment managers and the investment consultant's records. Also establish a formal oversight function for the tasks completed by the investment consultants.

- Because the appraised value is one of the key components in determining the System's net asset value in real estate partnerships, a formal process should be established to verify that appraised values are properly reflected in the partner's financial statements. For real estate partnerships that were not appraised as of the System's fiscal year-end, appropriate personnel should review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

- Reconcile subsidiary ledgers to the general ledger to ensure the accuracy of financial information and minimize the risk of misstatement or misappropriation. Management should establish a policy, whereby all subsidiary ledgers are reconciled to the general ledger on a monthly basis. In addition, appropriate management-level personnel should review the reconciliations for accuracy and document evidence of their review for audit purposes.

- Any variances identified in the reconciliations should be investigated and resolved as soon as possible.

Management Response:

Historically, to allow for timely financial reporting, OST has provided PERS with June 30th private equity, real estate and opportunity investment balances derived from cash adjusted March 31st valuations. OST has a process in place to review these estimates of fair value. Effective fiscal year ended 2011, PERS' financial statements reflected estimated fair values for private equity, real estate and opportunity investments based on the investment managers' June 30th investment balances, this change in fiscal year 2011 did not allow sufficient time for OST to review the investment managers' June 30th data. Going forward, OST will modify the review process to ensure that June 30th data is reviewed. However, this will cause a significant delay in when PERS receives the information needed to complete their financial statement preparation. OST will implement this change for fiscal year 2012.

OREGON PUBLIC EMPLOYEES RETIREMENT SYSTEM
Schedule of Findings and Recommendations (Continued)
Significant Deficiencies
For the Year Ended June 30, 2011

As part of an Investment Accounting Redesign project initiated in 2011, OST is currently taking a look at improvements that can be made to the reconciliation process. Due to limited OST staffing, many of the reconciliations are performed by third party consultants. OST will work to identify process improvements to our oversight of those consultants. This project is expected to be completed by June 30, 2013.

jClarety was not designed to report account balances except at the individual level. Reconciling jClarety to the General Ledger will require additional research and may require additional system modifications. We will work with our Business Process Owners and IT department to determine a solution and implementation timeline. Monthly pension roll activity reported by jClarety has been reconciled to the general ledger since implementation in June of 2011. Daily activity will be reviewed and a methodology will be developed by June 30, 2012.