Richard A. White, Jr.
Retirement Administrator

Telephone: (707) 463-4328
(707) 467-6473
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MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date:	February 19, 2014
To:	Board of Retirement
From:	Richard White, Retirement Administrator RAW
Subject:	(1) Schedule of Employer Contributions
	(2) Financial Statements and Audit Report for the year ended June 30, 2013

(1) Schedule of Employer Contributions.

Discussion: The Board of Retirement requested a review of the "Schedule of Employer Contributions" chart found in the annual audit report because the schedule shows that the percentage of employer contributions made to the Retirement Association at various times during the prior actuary's tenure with MCERA was not one hundred percent.

The Audit and Budget Committee reviewed and discussed the report at their February 5, 2014 meeting and recommended the memorandum for approval to the Board of Retirement on a 3 – 1 (Stephens) vote.

Recommendation action:

Accept the Schedule of Employer Contribution report as provided for in the financial statements and incorporate comments regarding this schedule in the Management Discussion and Analysis section of the Audit Report.

(2) Financial Statements and Audit Report for the year ended June 30, 2013.

Discussion: Each year MCERA conducts an audit of its financial condition as required by Government Code Section 31593. Per the code section, the Board may retain the services of a Certified Public Accountant (CPA) or use the County Auditor-Controller. The Association retained Gallina, LLP to conduct the annual audit of our financial statements and supplementary information for the year ended June 30, 2013. The draft audit, prepared by Daniel Matzinger and Crystal Ekanayake, is included in your Board materials for your review, discussion and approval at the Board meeting.

The Audit and Budget Committee reviewed and discussed this report at their February 5, 2014 meeting and recommended the approval to the Board of Retirement on a 4 – 0 vote.

The report is provided under separate cover for your review and discussion.

Daniel Matzinger and Crystal Ekanayake, Gallina LLP will be happy to address any questions related to the audit.

Recommended Motion/Action:

1. Accept the independent audit prepared by Gallina, LLP.
2. Transmit a copy of the audit to the Board of Supervisors per GC Section 5193, the Auditor-Controller, and State Controller's Office.

Alternatives:

None that provide for compliance with GC Section 5193.

Government Code Section:

§31593. Audit and report

The retirement board shall conduct an audit of the retirement system at least once every 12 months and report upon its financial condition. The retirement board may retain the services of a certified public accountant to perform the annual audit. That audit shall be performed in accordance with generally accepted auditing standards. The cost of the audit shall be considered a cost of the administration of the retirement system. The audit report shall address the financial condition of the retirement system, internal accounting controls, and compliance with applicable laws and regulations. A copy of the audit report shall he filed with the board of supervisors.

Nothing in this section shall preclude the retirement board from selecting the county auditor to perform the annual audit, and if so done, the cost of that audit shall he considered a cost of the administration of the retirement system.

At the request of the county board of supervisors, the county auditor may audit the accounts of the retirement system. The expense of that audit shall not be a cost chargeable by the county to the retirement system.

(Added by Stats. 1947, Ch. 424, Sec. 1)
(Repealed and added by Stats. 1998, Ch. 109 (A.B. 1766), Sec. 5 and 6)

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UKIAH, CALIFORNIA 95482-5027

Date:	February 19, 2014
To:	Board of Retirement
From:	Richard White, Retirement Administrator RAW
Subject:	Schedule of Employer Contributions

Recommendation:

Accept the Schedule of Employer Contribution report as provided for in the financial statements and incorporate comments regarding this schedule in the Management Discussion and Analysis section of the Audit Report.

The Audit and Budget Committee recommended this memorandum to the Board of Retirement on a 3 – 1 (Stephens) vote.

Recommended language for the MD&A:

The Board of Retirement is aware that the schedule as prepared makes it appear that contributions were not made, but cannot find any evidence that contributions are due MCERA by the adopting employers for those years and that the Board believes that the plan is in compliance under the CERL.

A review of the contribution data does not provide a clear explanation for the variances away from the one hundred percent figure though it appears that the schedule was prepared with a method which included 'estimated annual required contributions' (computed with payroll as estimated by the actuary in their valuation) at times and 'actual required contributions' (computed with actual payroll reported by the employers in the payroll system) at other times. For example, in the most recent time periods, the current MCERA actuary applied the actual contributions received to the Schedule, without regard to the estimated contribution, which resulted in the one hundred percent result.

This method 'presumes' that the recommended and adopted employer contribution rates are applied by the employers to the proper payroll in that period and that the application of the adopted contribution rates to the proper payroll resulted in the amount of employer contributions supplied to the actuary by the auditor in the financial statements for MCERA. Correctly imputed and applied contribution rates in the payroll systems of our plan sponsors will result in the proper amount of contributions being made.

MCERA has no reason to believe that this process was not correctly done in any of the annual periods identified on the Schedule of Employer Contributions even during the prior actuary's tenure with MCERA. While the Schedule of Employer Contributions is confusing, it appears based upon the limited information currently available, that the employer contributions received by the Retirement Association were in fact the annually required amounts based upon the actual payroll of the plan sponsors and application of the adopted contribution rates for the time periods involved.

DISCUSSION: The Board of Retirement requested a review of the "Schedule of Employer Contributions" chart found in the annual audit report because the schedule shows that the percentage of employer contributions made to the Retirement Association at various times during the prior actuary's tenure with MCERA was not one hundred percent.

The one hundred percent figure is important because the CERL states that contribution amount be adjusted by the County Auditor at the end of the fiscal year to reflect the actual contribution required for that year. (GC section 31582(b)).

The confusion can be demonstrated by viewing two years from the Schedule of Employer Contribution Report; one year showing less than one hundred percent and one year showing more than one hundred percent. In both cases, it appears that the calculation was based upon the 'estimated amount of contributions' rather than on the 'actual amount of contributions' received from the plan sponsors.

The Schedule of Employer Contribution report for the year ended June 30, 2010:

Year Ended	**Estimated annual amount of employer contributions**	**Actual amount of employer contributions**	**Percentage Contributed**
6-30-2010	$9,571,000	$8,234,253	91%

As viewed in the table above, the actuary **estimated** the amount of employer contributions in the actuarial valuation report dated 6-30-2010 to be $9,571,000. The **actual** amount of employer contributions as reported in the audit report was $8,234,253.

The Schedule of Employer Contribution indicates that the amount of employer contribution was less than one hundred percent, but it appears that this indicates only that the actual amount contributed was less than the estimated annual contribution amount and not that the employer contributed an amount less than the required amount (reported as 91% but may have been 86%).

This same result can be demonstrated again where the Schedule of Employer Contribution Report with the year ending **June 30, 2009.** This time, the Schedule shows that the employers made more than one hundred percent of contributions.

Year Ended	**Estimated annual amount of employer contributions**	**Actual amount of employer contributions**	**Percentage Contributed**
6-30-2009	$6,046,000	$8,561,368	141%

As viewed here, the actuary **estimated** the amount of employer contributions in the actuarial valuation report dated 6-30-2009 to be $6,046,000. The **actual** amount in the Audit report was $8,561,368 which is substantially more that one hundred percent of the estimated amount and reported as such on the Schedule as 141%. (Note: The County of Mendocino did make more than the required contributions).

CONCLUSION: These are two examples used to show that the information in the table is confusing and may lead a reader of the Schedule of Employer Contributions to reach an improper conclusion that the employers did not make the required contributions, as required under the CERL. In both cases, MCERA believes that the amounts could have been reported as one hundred percent because the employers made the proper calculations required at the time the payroll was issued which resulted in the correct employer contribution amount being sent to MCERA.

However, before the amounts previously reported in the Schedule of Employer Contribution table can be restated, they would have to be fully vetted which would require extensive and expensive accounting work that is substantially beyond the resources currently available to the Board of Retirement within MCERA staff and professional service providers.

The Board's professional service providers (Auditor and Actuary) have, at different times in the recent past, provided comments about the questions raised on the Schedule of Employer Contributions and have recommended that the Schedule be reported as prepared and that efforts to reconstruct the table would be difficult to do because the methodology is not known (for instance, it is not clear why the above comparison of actual to estimated contributions only matched for 2009 but not for 2010) and is not worth the effort because the data will eventually drop from the tables in current use.

This report has been reviewed by both of our professional service providers, which included the recommendation of Gallina that these comments be included in the MD&A.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)

Financial Statements
and Supplementary Information
for the year ended June 30, 2013

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Financial Statements and Supplementary Information
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Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Board of Retirement
June 30, 2013

GALLINA LLP
CERTIFIED PUBLIC ACCOUNTANTS

Independent Auditor's Report

To the Board of Retirement
Mendocino County Employees' Retirement Association
Ukiah, California

Report on the Financial Statements

We have audited the accompanying financial statements of Mendocino County Employees' Retirement Association (MCERA), a component unit of the County of Mendocino, which comprise the statement of net assets available for benefits as of June 30, 2013, and the related statement of changes in net assets available for benefits for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Plan management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. 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 Governmental Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to MCERA's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of MCERA's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Board of Retirement
Mendocino County Employees' Retirement Association
Independent Auditor's Report

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of MCERA as of June 30, 2013, and the changes its financial status for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Report on Supplemental Information

Management's Discussion and Analysis on pages 5 through 9, and other required supplementary information listed in the table of contents are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Gallina LLP
Rancho Cordova, California
January 13, 2013

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Management's Discussion and Analysis (unaudited)
June 30, 2013

The following section provides an overview and analysis of the Mendocino County Employees' Retirement Association (MCERA) financial activities for the year ended June 30, 2013. We encourage readers to take into account the information presented here in conjunction with additional information we have furnished in the financial statements.

Mendocino County Employees' Retirement Association (MCERA)

MCERA provides service retirement, disability, death and survivor benefits and is administered in accordance with the County Employees Retirement Law of 1937 (Government Code Section 31450, et seq.) Pursuant to certain provisions of the County Employees Retirement Law, MCERA is a multi-agency public employees' retirement system, established by the County of Mendocino on January 1, 1948, and is an independent district within the County of Mendocino, with a separate operating budget and professional staff.

The California Constitution gives the Board of Retirement (Board) plenary authority over the administration of the system, which includes administering plan benefits and managing the assets. The Board of Retirement and MCERA staff members are committed to act for the exclusive benefit of the plan and its participants, manage the assets of the plan prudently and administer benefits with impartiality.

To fulfill this mandate, MCERA employs a skilled professional staff and independent consultants that operate under a system of governance, operational and fiduciary policies and procedures.

Participating agencies in MCERA include the County of Mendocino, the Superior Court of Mendocino and the Russian River Cemetery District.

Financial Highlights

Net assets available for benefits increased to $383.2 million which reflects an increase of 11.80% in net assets during Fiscal Year 2012-13. Additions to plan assets for the fiscal year were $67.9 million. This was comprised of $14.3 million of employer contributions, $4.7 million of member contributions and a net investment gain of $48.9 million. Expenses (deductions in plan assets) for the year were $27.4 million which included $26.6 million in benefit payments to retirees and beneficiaries and $0.8 million in administrative expenses.

Budget

The Board of Retirement approves MCERA's annual budget. The County Employees Retirement Law (CERL) limits MCERA's annual administrative expenses, excluding the costs of administration for computer software and hardware and computer technology consulting services (IT costs), to twenty-one hundredths of one percent (0.21%) of MCERA's actuarial accrued liability or $2 million, whichever is greater. Previously, the limit was eighteen hundredths of one percent (0.18%) of MCERA's total assets.

MCERA's actual administrative expense was $829,999 which represented 0.17% of MCERA's actuarial accrued liability or 41.5% of the $2 million statutory cap.

<u>**Overview of the Financial Statements**</u>

Managements' Discussion and Analysis serves as an introduction and overview of the MCERA Basic Financial Statements. The Basic Financial Statements and required disclosures are prepared in accordance with accounting principles and reporting guidelines as set forth by the Governmental Accounting Standards Board (GASB). MCERA's Basic Financial Statements are comprised of the following:

Statement of Net Assets Available for Benefits
The Statement of Net Assets Available for Benefits is a snapshot of account balances at year-end. It presents major categories of assets and liabilities at fiscal year-end. The difference between assets and liabilities, "Net Assets Available for Benefits," represents funds available to pay benefits. Increases and decreases in "Net Assets Available for Benefits," when analyzed over time, may serve as an indicator of whether MCERA's financial position is improving or deteriorating.

Statement of Changes in Net Assets Available for Benefits
The Statement of Changes in Net Assets Available for Benefits provides information on the financial activities that increased and decreased Plan Net Assets. This statement covers the activity over a one-year period of time.

Notes to the Financial Statements
The Notes to the Financial Statements are an integral part of the basic financial statements and provide background and detailed information regarding MCERA's policies, programs and activities.

Required Supplemental Information
The Required Supplemental Information contains supporting schedules pertaining to MCERA's Pension actuarial methods, assumptions, funded status and annual required contributions.

<u>**Management Responsibility of Financial Reporting**</u>

MCERA management is responsible for establishing a system of internal control to safeguard assets and for the complete and fair presentation of the financial information in accordance with generally accepted accounting principles (GAAP) in the United States. To the best of our knowledge, the enclosed data is accurate in all material respects and is reported in a manner designed to fairly present the financial position and operating results of MCERA.

Major Initiatives and Significant Events

Several major initiatives were undertaken during the year including:

- The Board of Retirement engaged in a strategic planning session which led to the adoption of a mission statement, core values, goals and objectives for MCERA.
- Implemented the initiatives included in the pension reform legislation.
- Selected a service provider to install a pension administration system.
- Enhanced Board governance with the adoption of various charter and policies.
- Adopted significant revisions to the disability application procedures.
- Adopted changes to the actuarial funding policy.
- Implemented the initiatives included in the pension reform legislation known as PEPRA (California Public Employees' Pension Reform Act of 2013).

Accounting Systems and Reports

MCERA management is responsible for establishing a system of internal control to safeguard assets and for the presentation of the accompanying basic financial statements. Oversight is provided by MCERA Audit and Budget Committee. Gallina LLP audited the accompanying basic financial statements and related disclosures.

The CAFR was prepared in accordance with GAAP and reporting guidelines set forth by the Governmental Accounting Standards Board (GASB) and the County Employees Retirement Law of 1937. GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of management discussion and analysis (MD&A).

This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. MCERA's MD&A can be found immediately following the independent auditor's report.

Investment and Economic Summary

In accordance with state constitutional mandates, the Board adopts a strategic asset allocation policy designed to ensure diversification among asset classes and achieve MCERA's long-term investment objectives. Although MCERA invests on a long term horizon, short term returns are important to keep in mind.

The investment return for the year ending June 30, 2013 was 14.52% which was ahead of the benchmark by 2.23%. The returns were 11.36%, 5.71% and 5.95% for three, five and seven year periods ending June 30, 2013, respectively.

The Association maintains an assumed rate of investment return of 7.75% per year. The rate of return on MCERA's investment portfolio is an integral component of the annual additions to the pension plan as total investment income is typically the largest contributor to the Plan's annual additions to retirement plan assets.

Funded Status and Actuarial Reporting

MCERA maintains a funding goal to establish contributions that fully fund the System's liabilities, and that, as a percentage of payroll, remain as level as possible for each generation of active members. Actuarial valuations are performed annually with actuarial experience investigations conducted triennially in accordance with state statute. The use of realistic assumptions is important in maintaining the necessary funding while paying promised benefits. Each year the actual experience of the System is compared to our assumptions and the differences are studied to determine whether changes in the contribution requirements are necessary. In addition, triennially, the actuarial experience investigation is undertaken to review the actuarial assumptions and compare the actual experience during the preceding three year period with that expected under those assumptions.

In December 1996, the County issued its Taxable Pension Obligation Bonds (POBs) in the aggregate principal amount of $30,720,000. In December 2002, the County issued its Taxable Pension Obligation Bonds, Refunding Series 2002 in the aggregate principal amount of $91,945,000 to defease a portion of the 1996 POBs and to provide funds to allow the County to refund its then current unfunded actuarial accrued liability for retirement benefits for County employees. The County has contributed to the Association an aggregate amount of $106,411,000 from the issuance of the 1996 POBs and the 2002 POBs to reduce the UAAL. As of June 30, 2013, the 2002 POBs are outstanding in the principal amount of $76,000,000 with annual payment requirements of approximately $8,000,000 due in July of each year until July 2026.

In the June 30, 2013 valuation, the ratio of actuarial value of assets to the actuarial value of liabilities was 74.2% which was an increase from the prior year's valuation funded ratio of 74.1%. The Association's unfunded actuarial liability (UAAL) as of June 30, 2013 was $131,684,255. As of June 30, 2013, there are 26 years remaining in the declining 30-year amortization period of the UAAL.

The aggregate employer rate calculated in this valuation increased to 26.28% of payroll from 25.65% in last year's valuation. The aggregate employee rate decreased to 9.62% of payroll from 9.76% in last year's valuation. The aggregate rate as of June 30, 2012 was recalculated for the current year actuarial valuation report which indicated that the aggregate employer rate was 25.48% and the aggregate employee rate was 9.60%. Thus, using the recalculated figures, the aggregate employer rate in this valuation increased to 26.28% of payroll from 25.48% in last year's valuation and the aggregate employee rate increased to 9.62% of payroll from 9.60% in last year's valuation.

Request for Information

The financial report is designed to provide the MCERA Board of Retirement, our membership, taxpayers, investment managers and creditors with a general overview of MCERA finances and to account for the money it receives. Questions concerning any of the information in this report or requests for additional financial information should be addressed to:

Mendocino County Employees' Retirement Association
625-B Kings Court
Ukiah, CA 95482

Respectfully submitted,

Richard A. White, Jr.
Retirement Administrator

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Statement of Net Assets Available for Benefits
June 30, 2013

Assets

Investments, at fair value:		
Mutual funds		$ 304,575,349
Public equity securities		42,628,539
Real estate partnerships		32,994,779
Cash equivalents		2,144,879
Real estate - 625 Kings Court, Ukiah, CA		864,000
Total investments, at fair value		383,207,546
Receivables:		
Members' contributions	$ 81,192	
Employers' contributions	233,170	
Total receivables		314,362
Other assets		13,162
Total assets		$ 383,535,070

Liabilities

Liabilities:	
Accounts payable	$ 114,416
Accrued expenses and other liabilities	223,837
Total liabilities	$ 338,253

Net Assets Available for Benefits

Net assets available for benefits	$ 383,196,817

See accompanying notes.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Statement of Changes in Net Assets Available for Benefits
for the year ended June 30, 2013

Additions (deductions) to net assets attributed to:		
Investment income (expense):		
Net appreciation in fair value of investments		$ 41,174,278
Rent income, net of expenses		76,752
Interest income		23,223
Dividend income		8,248,645
Investment expenses		(632,406)
Net investment income		48,890,492
Contributions:		
Members'	$ 4,712,593	
Employers'	14,260,473	
Total contributions		18,973,066
Total additions, net		67,863,558
Deductions from net assets attributed to:		
Benefits paid to retirees	26,573,554	
Administrative expenses	829,999	
Total deductions		27,403,553
Net increase		40,460,005
Net assets available for benefits:		
Beginning of year		342,736,812
End of year		$ 383,196,817

See accompanying notes.

Note 1: Description of Plan:

Description of Association and Applicable Provisions of the Law:

The Mendocino County Employees' Retirement Association (MCERA, Association, or the Plan) is an integrated public retirement system established under and subject to the legislative authority of the State of California as enacted and amended by the County Retirement Act of 1937 (Chapter 677 Statutes of 1937). MCERA is a multiple-employer cost sharing defined benefit plan for the County of Mendocino, the Mendocino County Courts, and the Russian River Cemetery District (the Plan Sponsors). MCERA was approved by the Board of Supervisors to become effective January 1, 1948, and was integrated with Social Security on January 1, 1956.

Membership in the Plan at June 30, 2013 consisted of the following:

Retirees and beneficiaries receiving benefits	1,287
Terminating plan members entitled to but not yet receiving benefits	345
Active plan members	1,072
Total	2,704
Number of participating employers	3

A cost-sharing multiple employer plan is a single plan with pooling (cost-sharing) arrangements for the participating employers. All risks, rewards, and costs, including benefit costs, are shared and are not attributed individually to the employers. A single actuarial valuation covers all plan members. Other special districts within Mendocino County are eligible, but have not elected to participate.

All permanent employees who work at least 32 hours per week become members of the Plan on the first day of the pay period following employment. Employees are classified as either General or Safety (Law Enforcement or Probation) members, and are assigned to one of five tiers based on entry date and job classification.

Retirement benefits offered by the Plan include normal retirement, disability retirement and service-connected disability retirement. A death benefit is available to beneficiaries. An annual cost of living adjustment of no more than 3 percent may be granted by the Board of Retirement.

Note 1: Description of Plan, continued:

Description of Association and Applicable Provisions of the Law, continued:

The Cost of Living Adjustment may be increased up to the maximum of three percent (3%) by applying accumulated adjustments carried forward from those years where the increase in the reported cost of living exceeded three percent. Effective April 1, 2013, for benefit recipients who began receiving benefits on or before April 1, 1985, their allowances will be increased by a 3.0% COLA, with 1.0% deducted from their COLA banks. For benefit recipients who began or will begin receiving benefits on April 2, 1985 through April 1, 2013, their allowances will be increased by 2.0% with no reduction in their COLA banks, since their COLA banks are presently at zero.

Health benefits for retired employees have been funded by the Plan in the past. Reimbursements of retiree medical costs paid by the County of Mendocino were made in the past from a MCERA account established with "excess earnings" as allowed under the CERL and intended to represent a retiree medical account under section 401(h) of the Internal Revenue Code. There were no amounts paid from the retiree medical account during the year ended June 30, 2013. MCERA filed an application with the Internal Revenue Service (IRS) in January 2011 for a determination letter as to the tax qualified status of the system and also filed under the IRS voluntary correction program (VCP) procedure. The IRS is reviewing these applications and under its normal process will respond to MCERA regarding its filings. Any issues regarding compliance of the retiree medical account with Internal Revenue Code section 401(h) are included in the IRS review and will be addressed as part of that process.

Note 2: Summary of Significant Accounting Policies:

Reporting Entity:

MCERA is governed by the Board of Retirement and is considered an independent entity. The Association is a component unit of the County of Mendocino and is being reported as a Pension Trust Fund in the County's Financial Report in accordance with Governmental Accounting Standards Board Statement No. 14.

Basis of Accounting:

The Association follows Governmental Accounting Standards Board (GASB) accounting principles and reporting guidelines, and financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to the Plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of the Plan.

Note 2: Summary of Significant Accounting Policies, continued:

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Retirement Administrator to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

Derivatives:

MCERA's investment policy permits the use of derivative instruments to minimize the exposure of certain of its investments to adverse fluctuations in financial and currency markets and enhance yields. MCERA does not use derivatives for speculative use or to create leverage.

During the year ended June 30, 2013 MCERA owned no derivatives directly in its portfolio.

Custodial Credit Risk:

Custodial risk for deposits in the Mendocino County trust account is assumed by the County of Mendocino. Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, MCERA would not be able to recover the value of the investment or collateral securities that are in possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in MCERA's name, and held by the counterparty. MCERA's investment securities are not exposed to custodial credit risk because all securities are held directly with various investment companies in MCERA's name.

Except for a statement that duties of the Board of Retirement, MCERA officers and employees shall be discharged with care, skill, prudence, and diligence, MCERA has no formal policy for managing custodial credit risk.

Market and Credit Risk:

The Plan invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect account balances and the amounts reported in the statement of net assets available for benefits and the statement of changes in net assets available for benefits.

Note 2: Summary of Significant Accounting Policies, continued:

Market and Credit Risk, continued:

Credit risk is the risk that an issuer or other counterparty to a debt instrument will not fulfill its obligations. This is measured by the assignment of ratings by nationally recognized statistical rating organizations. Investment allocation guidelines according to the investment policy are as follows:

	Allowable Range	Current Allocation
U.S. Equity	33% - 43%	41%
Non-U.S. Equity	20% - 30%	26%
U.S. Fixed Income	23% - 33%	24%
Real Estate	4% - 14%	9%

MCERA's Investment Policy does not allow for a single investment in real estate that is in excess of 5% of total assets. With respect to common stocks, MCERA has a goal of diversifying the portfolio among a cross-section of industries that have sound long-term growth potential. Similar restrictions apply to fixed income securities.

Interest Rate Risk:

Interest rate risk is the risk that changes in the interest rate will adversely affect the fair value of an investment. MCERA has not adopted a formal policy to manage interest rate risk.

Member Termination:

Upon separation from MCERA, members' accumulated contributions are refundable with interest accrued through the prior June 30 or December 31. Interest on member accounts is credited semiannually on June 30 and December 31. Withdrawal of such accumulated contributions results in forfeiture of the related vested benefits.

Plan Termination:

MCERA is administered in accordance with the provisions of California Government Code Section 31450 and accompanying code sections. California Government Code Section 31483 allows the governing body of the County, the County Courts, or special district, through the adoption of an ordinance or resolution, to terminate the applicability of the Plan to employees of the County, Courts, or district whose services commence after a given future date.

Note 2: Summary of Significant Accounting Policies, continued:

Risk Management:

MCERA is exposed to various risks of losses related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; natural disasters; and major downturns in financial markets. For the past several years, MCERA has obtained coverage from commercial insurance companies for errors and omissions coverage related to activities of the Board of Retirement, but all other risks of loss, except losses due to depreciation in the fair market value of investments, is assumed by the sponsoring employers. MCERA has effectively managed risk through various employee education and prevention programs and careful selection of investments. Expenditures and claims are recognized when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated.

The Mendocino County Department of Human Resources administers the retiree medical program for County retirees. As described in Note 1, MCERA filed an application with the IRS in January 2011 for a determination letter as to the tax qualified status of the system and also filed under the IRS VCP procedure. If in preparing for a determination letter application filing with the IRS, the retirement system determines that there are issues about the tax rules as applied to that system, the IRS also encourages the system to file an application under its VCP procedure. The IRS is reviewing MCERA's determination letter and VCP applications and under its normal process will respond to MCERA regarding its filings. Any issues regarding compliance of MCERA with the Internal Revenue Code, including compliance of the retiree medical account with Code section 401(h), are included in the IRS review and will be addressed as part of that process.

Based on Mendocino County Board of Supervisors Resolution No. 98-147, County Counsel concluded that the County Board of Supervisors was ultimately responsible for dealing with any retiree health benefits that might be provided to retired employees of the County. MCERA therefore had no incurred but not reported claims as liabilities showing on the financial statements for the year ended June 30, 2013. For the year ended June 30, 2013, MCERA had no "excess earnings" as defined under the CERL that could be used for the payment or reimbursement of retiree health benefits under a Code section 401(h) account.

Current and Future Accounting Pronouncements:

GASB Statement No. 53 - *Accounting and Reporting for Derivative Instruments* became effective for all years beginning after June 15, 2009. This statement provides a comprehensive framework for the measurement, recognition, and disclosure of derivative instrument transactions. If MCERA invests in derivative instruments in the future, this statement will be used to measure, recognize, and disclose those transactions.

Note 2: Summary of Significant Accounting Policies, continued:

Current and Future Accounting Pronouncements, continued:

GASB Statement No. 61 - *The Financial Reporting Entity: Omnibus - an amendment of GASB Statements No. 14 and No. 34*, modifies certain requirements for inclusion of component units in the financial reporting entity, and amends the criteria for reporting component units as if they were part of the primary government. Although the provisions for this statement are effective for fiscal years beginning after June 15, 2012, it seems to clarify and confirm the existing relationship of MCERA as a component unit of the County of Mendocino.

GASB Statement No. 62 - *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, effective for periods beginning after December 15, 2011, will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source.

Subsequent Events:

Management has evaluated all subsequent events through January 13, 2013, the date the financial statements were available to be issued. See Note 7 for additional information.

Note 3: Investments:

Investments are reported at fair value. Investments that do not have an established market are reported at estimated fair value. All investments listed in the Statement of Net Assets Available for Benefits, except for real estate and cash equivalents, are registered securities held by the Association's agent in the Association's name. The Board of Retirement has exclusive control over all investments of the Association and is responsible for establishing investment objectives, strategies and policies.

The Board of Retirement has adopted an Investment Policy, which provides the framework for the management of MCERA's investments. The Investment Policy establishes MCERA's investment objectives and defines the principal duties of the Board of Retirement and the investment managers. The asset allocation plan is an integral part of the Investment Policy and is designed to provide an optimum and diversified mix of asset classes with return expectations to satisfy expected liabilities while minimizing risk exposure. MCERA currently employs investment managers to manage its assets subject to the provisions of the Investment Policy.

Note 3: Investments, continued:

Cash equivalents consist of cash in trust with the Treasurer of the County of Mendocino. Cash from deposits and cash needed for daily operational purposes is held in a pooled account with other County funds. The County Treasurer is responsible for the management, control and safekeeping of all investments in the pooled fund. Interest on funds in the County investment pool is computed quarterly based on average daily balance. A deposit in the pooled account approximates fair value.

Security transactions are accounted for on a trade date basis. Interest income is recognized when earned and dividend income is recognized on the ex-dividend date. Stock dividends or stock splits are recorded as memo items and do not affect the total value of the securities. Unrealized gains and losses on investments are reported as "net appreciation (depreciation) in fair value of investments." The calculation of realized gains and losses is independent of the calculation of net appreciation (depreciation) in the fair value of Plan investments.

The Association's cash and investments stated at fair value as of June 30, 2013, are as follows:

Cash in trust - Mendocino County	$ 2,144,879
Total cash equivalents	2,144,879
U.S. Government and corporate bonds	93,171,941
International equities	79,092,535
Domestic equities - small cap	25,054,335
Domestic equities - mid cap	19,618,107
Domestic equities - large cap	87,638,431
Total mutual funds	304,575,349
Public equity securities	42,628,539
Real estate partnerships	32,994,779
Real estate - 625 Kings Court, Ukiah, CA	864,000
Total investments	$ 383,207,546

Note 4: Fair Value Measurement of Investments:

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC 820 are described below:

Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Plan has the ability to access.

Level 2: Inputs to the valuation methodology include: quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The following is a description of the valuation methodologies used for investments measured at fair value. There have been no changes in the methodologies used at June 30, 2013.

Mutual funds, public equity securities, and real estate partnerships: Valued at the net asset value of shares held by the Plan at year end.

Real estate – 625 Kings Court, Ukiah, CA: Valued at the approximate appraised fair value.

The methods described above may produce a fair value calculation that may not be as indicative of net realizable value or reflective of future fair values. Furthermore, while the Plan believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Notes to the Financial Statements, continued
June 30, 2013

Note 4: Fair Value Measurement of Investments, continued:

The following tables set forth by level, within the fair value hierarchy, MCERA's investments at fair value as of June 30, 2013:

	Investments at Fair Value as of June 30, 2013			
	Level 1	Level 2	Level 3	Total
Mutual funds:				
Bond funds	$ 93,171,941	$ -	$ -	$ 93,171,941
International securities	79,092,535	-	-	79,092,535
Domestic securities	132,310,873	-	-	132,310,873
Total mutual funds	304,575,349	-	-	304,575,349
Public equity securities	42,628,539	-	-	42,628,539
Real estate partnerships	32,994,779	-	-	32,994,779
Real estate - 625 Kings Court, Ukiah, CA	-	-	864,000	864,000
Total investments at fair value	$ 380,198,667	$ -	$ 864,000	$ 381,062,667

The following table sets forth a summary of changes in the fair value of the Plan's Level 3 investments for the year ending June 30, 2013:

	Real Estate - 625 Kings Court, Ukiah, CA
Balance, beginning of year	$ 738,992
Unrealized gains (losses)	125,008
Purchases	-
Sales	-
Issuances	-
Settlements	-
Balance, end of year	$ 864,000

Note 5: Contributions:

The actuarially determined member contribution rates payable for fiscal year 2014-15 average 9.62 percent of payroll. The actual member rate depends on the member's age at the time of hire, General, Safety, or Probation membership, and tier. For fiscal year 2014-15, employers are also required to contribute an actuarially determined rate of 26.28 percent of payroll in aggregate. The actual employer rate depends on General, Safety, or Probation membership, and tier. The member and employer contribution rates are adjusted annually to maintain the appropriate funding status of the Plan. The employer contribution rate is actuarially determined to provide for the balance of the contributions needed to fund the annual normal cost (basic and cost of living) and the amortization of the unfunded actuarial accrued liability.

The Plan had an unfunded actuarial accrued liability of $47,154,000 at June 30, 2001. This unfunded liability was being amortized through June 30, 2017, at which time it was anticipated the Plan would be fully funded. In December 1996, the Plan Sponsors issued pension obligation bonds, of which $30,112,488 of the proceeds were contributed to the Plan. In December 2002, due to a continued downward spiral of market values for MCERA investments, the Plan Sponsors issued additional pension obligation bonds. The total of bonds sold was $92,208,602, of which $76,299,000 was transferred to the Plan for additional investment, $13,220,061 was used to defease fifty percent of the 1996 pension obligation bonds, and the remainder of $2,689,541 was used to pay the costs of issuing the bonds. The proceeds from the 2002 pension obligation bonds reduced the unfunded pension liability to less than 10 percent of the actuarial accrued liability at June 30, 2004. The funding agreement in effect prior to July 1, 2009 indicated that the Plan Sponsors were not required to fund the UAAL that was not in excess of the target of 10 percent of the total pension liability. In November 2009, that funding agreement was voided by mutual agreement between the Association Board of Retirement and the Mendocino County Board of Supervisors. Subsequent to the funding agreement, the Board of Retirement stipulated that the Plan Sponsors must amortize the UAAL over a 30-year period from June, 2009.

The UAAL as of June 30, 2013 is $131.7 million, which the Plan Sponsors are required to amortize in the future. The funded ratio at June 30, 2013 is 74.2%, as indicated on the Schedule of Funding Progress on page 26. The *Actuarial Valuation and Review* report issued by The Segal Company as of June 30, 2013 recommended employer and member contribution rates that aggregate to 26.28% and 9.62%, respectively.

Note 5: Contributions, continued:

The information presented in the required supplementary schedules was determined as part of the actuarial valuation at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation date	June 30, 2013
Actuarial cost method	Entry age cost method (individual basis)
Amortization method	Level % of payroll for total unfunded liability
Remaining amortization period	26 years (declining/closed) for all UAAL
Asset valuation method	Market value of assets less unrecognized returns in each of the last five years. Unrecognized return is equal to the difference between the actual market return and the expected return on the market value, and is recognized over a five year period, further adjusted, if necessary, to be within 25% of the market value. The valuation value of assets is the actuarial value of assets reduced by the value of the non-valuation reserves.
Actuarial assumptions:	
Investment rate of return	7.75%
Inflation rate	3.50%
Real across-the-board salary increase	0.50%
Projected salary increases *	4.50% to 9.00%
* Includes inflation at	3.50% plus real across-the-board salary increase of 0.50% plus merit and longevity increases
Cost of living adjustments	3.00% of retirement income
Years of life expectancy after retirement	General members: RP-2000 Combined Healthy Mortality Table for males and females, set back 2 years for males and 1 year for females Safety/Probation members: RP-2000 Combined Healthy Mortality Table for males and females, with no setback for males and 1 year set forward for females.
Years of life expectancy after disability	General members: RP-2000 Combined Healthy Mortality Table for males and females, set forward 2 years. Safety/Probation members: RP-2000 Combined Healthy Mortality Table for males and females, set forward 4 years.

Note 5: Contributions, continued:

Life expectancy after retirement for employee contribution rate purposes	General members: RP-2000 Combined Healthy Mortality Table for males and females, set back 2 years for males and 1 year for females weighted 30% male and 70% female. Safety/Probation members: RP-2000 Combined Healthy Mortality Table for males and females, with no setback for males and 1 year set forward for females weighted 80% male and 20% female.

Using the projected payroll amounts for MCERA's membership groups and tiers that were used in the June 30, 2011 actuarial valuation, management has estimated the contributions are comprised of the following for the year ended June 30, 2013:

Estimated employer normal cost contributions	$ 7,403,034
Estimated UAAL contributions	6,857,439
Total	$ 14,260,473

Note 6: Reserves:

The Association had contingency reserves of $3,835,531, at June 30, 2013 to fund transfers to retirement reserve accounts in the event that sufficient earnings on investments are not received in the future to fulfill the requirement of transferring current earnings to the extent of 7.75 percent of retirement reserve balances to those reserves.

Member and employer contributions are allocated to various legally required reserve accounts based on actuarial determinations. A summary of the various reserve accounts, which comprise net assets available for pension and other benefits at June 30, 2013 (under the five-year smoothed asset valuation method for actuarial valuation purposes) is as follows:

Employee reserves	$ 57,319,952
Employer reserves	(48,388,438)
Retiree reserves	293,235,630
Undesignated reserves (Note 7)	658,654
1% contingency reserves	3,835,531
Settlement reserve	200,106
Miscellaneous reserves	235
Total reserves	306,861,670
Cumulative unallocated net unrealized gain on investments	75,750,705
Total allocated reserves (smoothed actuarial value after corridor limits)	382,612,375
Net assets in excess of reserves	584,442
Net assets held in trust of pension benefits	$ 383,196,817

The undesignated reserve used historically for providing health care benefits of retirees was derived from excess earnings of the Association in prior years.

Note 7: Subsequent Events:

Subsequent events are those events or transactions that occur subsequent to the effective date of the financial statements, but prior to the issuance of final reports, which may have a material effect on the financial statements or disclosures therein.

The fair value of assets in MCERA's portfolio has increased from $383 million to $405 million between July 1, 2013 and September 30, 2013. Capital markets continue to be highly volatile resulting in significant swings in market value, both positive and negative.

Since July 1, 2011, MCERA's new actuary, The Segal Company, determined that the employee basic contribution rate for fiscal years 2009-10, 2010-11 and 2011-12, as calculated by the prior actuary, was higher in the aggregate than it should have been. This resulted in a corresponding underpayment by employers during the same period. MCERA is working with a team of external and internal professionals to reimburse overpayments and collect underpayments to the pension fund based on the corrected rates, and in accordance with all tax laws and regulations. Corrected rates were in effect January 8, 2012, and the project is expected to be completed before the end of fiscal year 2013-14.

MCERA submitted a Voluntary Correction Program (VCP) filing with the IRS, stating that it recognized and posted excess earnings of $9.6 million, for fiscal years ending June 30, 2004 through 2006 that may not have been fully consistent with Government Code Section 31529.4 and/or IRC Section 401(h). The residual amount of excess earnings recognized and posted over this time period has been classified as "Undesignated reserves" and was $658,654 at June 30, 2013. The excess earnings postings are being reviewed by tax counsel, actuary, and an accounting firm to develop findings and recommendations for submission to the IRS. The IRS review on issues common to retirement systems such as MCERA that are maintained under the County Employees' Retirement Law of 1937 has begun. The IRS review, including any issues specific to MCERA, is expected to be completed sometime in calendar year 2014.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Required Supplementary Information (unaudited)
June 30, 2013

Schedule of Funding Progress (dollar amounts in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability ("AAL") - Entry Age (b)	Unfunded AAL ("UAAL") (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a % of Covered Payroll ((b - a) / c)
6/30/2006	$ 288,461	$ 320,123	$ 31,662	90.1%	$ 57,665	54.9%
6/30/2007	317,937	358,259	40,322	88.7%	65,899	61.2%
6/30/2008	353,421	373,832	20,411	94.5%	70,880	28.8%
6/30/2009	336,263	403,196	66,933	83.4%	72,235	92.7%
6/30/2010	343,202	434,987	91,785	78.9%	69,004	133.0%
6/30/2011	347,732	472,644	124,912	73.6%	64,144	194.7%
6/30/2012	362,487	489,014	126,527	74.1%	56,596	223.6%
6/30/2013	378,777	510,461	131,684	74.2%	56,464	233.2%

Schedule of Employer Contributions
(dollar amounts in thousands)

Year Ended	Annual Required Contribution	Percentage Contributed
6/30/2006	$ 4,996	79%
6/30/2007	7,533	100%
6/30/2008	7,232	100%
6/30/2009	6,046	141%
6/30/2010	9,571	91%
6/30/2011	9,554	100%
6/30/2012	11,811	100%
6/30/2013	14,260	100%