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

Financial Statements and Supplementary Information for the year ended June 30, 2014

GALLINA LLP
CERTIFIED PUBLIC ACCOUNTANTS

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(A Component Unit of the County of Mendocino)
Financial Statements and Supplementary Information
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(A Component Unit of the County of Mendocino)
Board of Retirement
June 30, 2014

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 position as of June 30, 2014, and the related statement of changes in net position 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.

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, 2014, and the changes to 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
February 4, 2015

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Management's Discussion and Analysis (unaudited)
June 30, 2014

The following section provides an overview and analysis of the Mendocino County Employees' Retirement Association (MCERA) financial activities for the year ended June 30, 2014. 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 agency 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 County and the Russian River Cemetery District.

Financial Highlights

Net position increased to $442.3 million which reflects an increase of 15.43% in net position during fiscal year 2013-14. Additions to plan assets for the fiscal year totaled $87.4 million. This was comprised of $14.3 million of employer contributions, $4.6 million of member contributions, $0.2 million in other income and a net investment gain of $68.3 million. Expenses (deductions in plan assets) for the year were $28.3 million which included $27.4 million in benefit payments to retirees and beneficiaries and $0.9 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.

Budget, continued

The Board of Retirement's policy is that administrative expenses incurred in any year will not exceed twenty-one hundredths of one percent (0.21%) of MCERA's actuarial accrued liability, unless authorized by a separate vote of the Board of Retirement.

MCERA's actual administrative expense for fiscal year 2013-14 was $930,437 which represented 0.16% of MCERA's actuarial accrued liability or 46.5% of the $2 million statutory cap.

Overview of the Financial Statements

Management's 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 Position
The Statement of Net Position 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 Position," represents funds available to pay benefits. Increases and decreases in "Net Position," when analyzed over time, may serve as an indicator of whether MCERA's financial position is improving or deteriorating.

Statement of Changes in Net Position
The Statement of Changes in Net Position provides information on the financial activities that increased and decreased Plan Net Position. 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 net pension liability, pension actuarial methods, assumptions, funded status and annual required contributions.

Management Responsibility of Financial Reporting

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 adopted new actuarial assumptions including a decrease in the assumed rate of return from 7.75% to 7.25% based on the triennial Actuarial Experience Study.
- MCERA initiated a search for a permanent Retirement Administrator and approved a new Financial/Investment Officer position.
- Work began on the implementation of the pension automation system.
- Adopted revisions to the disability application procedures.
- Completed an Asset Allocation and Liability study.
- The Internal Revenue Service (IRS) issued MCERA a favorable determination letter and compliance statement regarding the Plan's Voluntary Correction Program (VCP) which was filed in 2011.

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.

This transmittal letter 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).

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 discern developing trends.

Investment and Economic Summary, continued

The investment return for the year ending June 30, 2014 was 18.07% which was ahead of the benchmark by 0.80%. The returns were 10.19%, 13.29% and 5.96% for three, five and seven year periods ending June 30, 2014, respectively.

The Association adopted an assumed rate of investment return of 7.25% for the year ending June 30, 2014. The adopted rate is a 0.50% decrease from the prior year’s 7.75% assumed rate of return. 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 plan'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 to pay promised benefits. Each year the actual experience of the plan 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, 2014, the 2002 POBs are outstanding in the principal amount of $72,245,000 with annual payment requirements of approximately $8,000,000 due in July of each year until July 2026.

In the June 30, 2014 valuation, the ratio of actuarial value of assets to the actuarial value of liabilities was 69.3% which was a decrease from the prior year's valuation funded ratio of 74.2%. The actuarial value of assets excludes about $33 million in market gains that will be smoothed in over the next four years. Thus, on a market value basis, the funded ratio would be 75.7%. The Association's unfunded actuarial accrued liability (UAAL) as of June 30, 2014 was $179,573,042. On a market value basis, the UAAL would be $142,120,436. Both the decrease in the funded status and the increase in the UAAL on an actuarial valuation basis can be attributed mainly to the decrease in the assumed rate of return from 7.75% to 7.25%.

Funded Status and Actuarial Reporting, continued

As of June 30, 2014, there are 25 years remaining in the declining 30-year amortization period of the UAAL. On or after July 1, 2012 any new UAAL will be amortized over different amortization periods. New UAAL for each fiscal year which arises from investment gains and losses as well as variances from actuarial assumptions will be amortized over an 18-year period.

The aggregate employer rate calculated in the June 30, 2014 valuation increased to 33.38% of payroll from 26.00%. The change in the assumed rate of return accounted for 7.05% of the 7.38% net increase in the employer rate. Similarly, the aggregate employee rate increased to 10.15% of payroll from 9.30%.

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,

Jim Andersen
Interim Retirement Administrator

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Statement of Net Position
June 30, 2014

Assets

Investments, at fair value:		
Mutual funds		$ 347,155,558
Public equity securities		52,733,876
Real estate partnerships		36,669,201
Cash equivalents		4,966,310
Real estate - 625 Kings Court, Ukiah, CA		864,000
Total investments, at fair value		442,388,945
Receivables:		
Members' contributions	$ 104,280	
Employers' contributions	328,334	
Total receivables		432,614
Other assets		6,468
Total assets		$ 442,828,027

Liabilities

Liabilities:	
Accounts payable	$ 204,392
Accrued expenses and other liabilities	315,187
Total liabilities	$ 519,579

Net Position

Net position	$ 442,308,448

See accompanying notes.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Statement of Changes in Net Position
for the year ended June 30, 2014

Additions (deductions) to net assets attributed to:		
Investment income (expense):		
Net appreciation in fair value of investments		$ 61,820,076
Rent income, net of expenses		87,069
Interest income		27,807
Dividend income		6,863,134
Investment expenses		(503,242)
Net investment income		68,294,844
Contributions:		
Members'	$ 4,575,895	
Employers'	14,324,752	
Total contributions		18,900,647
Other income		200,106
Total additions, net		87,395,597
Deductions from net assets attributed to:		
Benefits paid to retirees	27,353,529	
Administrative expenses	930,437	
Total deductions		28,283,966
Net increase		59,111,631
Net position:		
Beginning of year		383,196,817
End of year		$ 442,308,448

See accompanying notes.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Notes to the Financial Statements
June 30, 2014

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, 2014 consisted of the following:

Retirees and beneficiaries receiving benefits	1,328
Terminating plan members entitled to but not yet receiving benefits	394
Active plan members	1,081
Total	2,803
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. The annual cost of living benefit is based upon the tier level of the member, but not available to new members hired after January 1, 2013.

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, 2014, for benefit recipients who began receiving benefits on or before April 1, 1985, their allowances will be increased by a 3.0% COLA, with 0.5% deducted from their COLA banks. For benefit recipients who began or will begin receiving benefits on April 2, 1985 through April 1, 2014, their allowances will be increased by 2.5% 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, 2014. On January 28, 2011 MCERA filed under the IRS voluntary correction program (VCP) procedure to correct past issues in the funding of health benefits for retired employees. The IRS reviewed this application and issued a compliance statement dated January 29, 2014 approving of the VCP procedure submitted by MCERA.

The Plan obtained its latest determination letter dated January 29, 2014, in which the IRS stated that the Plan, as then designed, is in compliance with the applicable requirements of the Internal Revenue Code.

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, 2014 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 position and the statement of changes in net position.

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%	39%
Non-U.S. Equity	20% - 30%	26%
U.S. Fixed Income	23% - 33%	26%
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. In addition, MCERA is also covered by the County's self-insurance program for general liability, unemployment, and workers' compensation coverage. The County's self-insurance program also includes a premium for excess coverage. 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 under the IRS VCP procedure to correct past issues in the funding of health benefits for retired employees. The IRS reviewed this application and issued a compliance statement dated January 29, 2014 approving of the VCP procedure submitted by MCERA.

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.

Administrative Expenses:

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.

Note 2: Summary of Significant Accounting Policies, continued:

Administrative Expenses, continued:

The Board of Retirement's policy is that administrative expenses incurred in any year will not exceed twenty-one hundredths of one percent (0.21%) of MCERA's actuarial accrued liability, unless authorized by a separate vote of the Board of Retirement.

MCERA's actual administrative expense was $930,437 which represented 0.16% of MCERA's actuarial accrued liability or 46.5% of the $2 million statutory cap.

Schedule of Funding Progress:

The supplemental Schedule of Funding Progress presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing relative to the actuarial accrued liability for benefits over time.

Current and Future Accounting Pronouncements:

GASB Statement No. 67 – *Financial Reporting for Pension Plans – an amendment of GASB Statement No. 25* effective July 1, 2013. The objective of this statement is to improve financial reporting by state and local government pension plans. This statement separates funding from financial reporting and requires changes in presentation of the notes to the financial statements and required supplementary information. Significant changes include an actuarial calculation of the total and net pension liability. It also includes comprehensive footnote disclosures regarding the pension liability and the sensitivity of the net pension liability to the discount rate. The total and net pension liability, determined in accordance with GASB Statement No. 67, is presented in Note 6 and in the required supplementary information on page 31.

GASB Statement No. 68 – *Accounting and Financial Reporting for Pensions – replaces GASB Statements 27 and 50* effective July 1, 2014. The objective of this statement is to improve financial reporting by state and local government pension plans. This statement requires cost-sharing government employers that sponsor defined benefit plans to recognize their proportionate share of the net pension liability in their statement of net position. An employer's proportion is required to be determined on a basis that is consistent with the manner in which contributions to the pension plan are determined, and consideration should be given to separate rates, if any, related to separate portions of the collective net pension liability. It also includes comprehensive footnote disclosures regarding the types of benefits and covered employees, how plan contributions are determined, and assumptions and methods used to calculate the pension liability.

Note 2: Summary of Significant Accounting Policies, continued:

Subsequent Events:

Management has evaluated all subsequent events through February 4, 2015, the date the financial statements were available to be issued. See Note 9 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 Position, 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 managing risk exposure. MCERA currently employs investment managers to manage its assets subject to the provisions of the Investment Policy.

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.

Note 3: Investments, continued:

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, 2014, are as follows:

Cash in trust - Mendocino County	$ 4,966,310
Total cash equivalents	4,966,310
U.S. Government and corporate bonds	115,476,682
International equities	90,904,226
Domestic equities - small cap	25,366,891
Domestic equities - mid cap	19,248,096
Domestic equities - large cap	96,159,663
Total mutual funds	347,155,558
Public equity securities	52,733,876
Real estate partnerships	36,669,201
Real estate - 625 Kings Court, Ukiah, CA	864,000
Total investments	$ 442,388,945

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, 2014.

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 fair value obtained through a broker price opinion.

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.

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, 2014:

	Investments at Fair Value as of June 30, 2014			
	Level 1	Level 2	Level 3	Total
Mutual funds:				
Bond funds	$ 115,476,682	$ -	$ -	$ 115,476,682
International securities	90,904,226	-	-	90,904,226
Domestic securities	140,774,650	-	-	140,774,650
Total mutual funds	347,155,558	-	-	347,155,558
Public equity securities	52,733,876	-	-	52,733,876
Real estate partnerships	36,669,201	-	-	36,669,201
Real estate - 625 Kings Court, Ukiah, CA	-	-	864,000	864,000
Total investments at fair value	$ 436,558,635	$ -	$ 864,000	$ 437,422,635

Note 4: Fair Value Measurement of Investments, continued:

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, 2014:

	Real Estate - 625 Kings Court, Ukiah, CA
Beginning balance	$ 864,000
Realized gains	-
Unrealized gains relating to instruments still held as of June 30, 2014	-
Purchases	-
Sales	-
Issuances	-
Settlements	-
Ending balance	$ 864,000
Amount of total gains or losses for the period included in net appreciation in fair value of investments, attributable to the change in unrealized gains or losses relating to assets still held as of June 30, 2014	$ -

The following table represents the Plan's level 3 financial instruments and the valuation techniques used to measure the fair value of those financial instruments as of June 30, 2014:

Instrument	Fair Value at June 30, 2014	Principal Valuation Technique
Real Estate-625 Kings Court, Ukiah, CA	$ 864,000	Fair Value = Broker Price Option

Note 5: Contributions:

The actuarially determined member contribution rates payable for fiscal year 2015-16 average 10.15 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 2015-16, employers are also required to contribute an actuarially determined rate of 33.38 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, 2014 is $179.6 million, which the Plan Sponsors are required to amortize in the future. The funded ratio at June 30, 2014 is 69.3%, as indicated on the Schedule of Funding Progress on page 32. The *Actuarial Valuation and Review* report issued by The Segal Company as of June 30, 2014 recommended employer and member contribution rates that aggregate to 33.38% and 10.15%, 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, 2014
Actuarial cost method	Entry age cost method (individual basis)
Amortization method	Level % of payroll for total unfunded liability
Remaining amortization period	25 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	7.25%
Inflation rate	3.25%
Real across-the-board salary increase	0.50%
Projected salary increases *	4.25% to 8.75%
* Includes inflation at	3.25% 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 for healthy members and all beneficiaries after retirement	For all members and all beneficiaries: RP-2000 Combined Healthy Mortality Table projected with Scale BB to 2020, set back 1 year for males and with no setback for females.

Note 5: Contributions, continued:

Years of life expectancy after disability	For all members: RP-2000 Combined Healthy Mortality Table projected with Scale BB to 2020, set forward 4 years for both males and females. The tables shown above were determined to contain sufficient provision appropriate to reasonably reflect future mortality improvemen based on a review of mortality experience as of the measurement date.
Life expectancy after retirement for employee contribution rate purposes	General members: RP-2000 Combined Healthy Mortality Table projected with Scale BB for 2020, set back 1 year for males and with no setback for females, weighted 30% male and 70% female. Safety and Probation members: RP-2000 Combined Healthy Mortality Table projected with Scale BB to 2020, set back 1 year for males and with no setback 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, 2012 actuarial valuation, management has estimated the contributions are comprised of the following for the year ended June 30, 2014:

Estimated employer normal cost contributions	$ 7,164,626
Estimated UAAL contributions	7,160,126
Total	$ 14,324,752

Note 6: Net Pension Liability:

GASB 67 requires public pension plans to provide a net pension liability. The net pension liability is measured as the total pension liability less the amount of the pension plan's net position. The net pension liability is an accounting measurement for financial statement reporting purposes. The components of MCERA's net pension liability at June 30, 2014 were as follows:

Total pension liability	$ 584,428,884
Net position	442,308,448
Net pension liability	$ 142,120,436
Net position as a percentage of total pension liability	75.7%

Disclosure of Information About Actuarial Methods and Assumptions:

The required Schedule of Changes in Net Pension Liability immediately following the Notes to the Financial Statements presents information about whether the plan fiduciary net position is increasing or decreasing over time relative to the total pension liability.

The projection of benefits for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations.

Actuarial Methods and Assumptions:

The total pension liability as of June 30, 2014 was determined by actuarial valuations as of June 30, 2014. The actuarial assumptions used in this June 30, 2014 valuation were based on the results of an experience study for the period from July 1, 2011 through June 30, 2014. They are the same as the assumptions used in the June 30, 2014 funding actuarial valuation for MCERA. Key methods and assumptions used in the latest actuarial valuation are presented below:

Valuation date	Actuarially determined contribution rates are calculated as of June 30, two years prior to the end of the fiscal year in which contributions are reported.
Actuarial cost method	Entry age cost method (individual basis)
Amortization method	Level % of payroll for total unfunded liability
Remaining amortization period	25 years (declining/closed) for all UAAL

Note 6: Net Pension Liability, continued:

Actuarial Methods and Assumptions, continued:

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	7.25%
Inflation rate	3.25%
Real across-the-board salary increase	0.50%
Projected salary increases *	4.25% to 8.75%
* Includes inflation at	3.25% plus real across-the-board salary increase of 0.50% plus merit and longevity increases.
Cost of living adjustments	3.00% of retirement income
Mortality for healthy members and all beneficiaries	Healthy: RP-2000 Combined Healthy Mortality Table projected with Scale BB to 2020, set back 1 year for males and with no setback for females.
Other assumptions	Same as those detailed in Note 5.

Assumed Asset Allocation:

The long-term expected rate of return on pension plan investments is determined using a building-block method in which expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These returns are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and adding expected inflation.

Note 6: Net Pension Liability, continued:

Assumed Asset Allocation, continued:

The target allocation and projected arithmetic real rates of return for each major asset class, after deducting assumed inflation of 3.25%, but before deducting investment expenses, used in the derivation of the long-term expected investment rate of return assumption are summarized in the following table:

	Target Allocation	Long-Term Expected Real Rate of Return
U.S. Large Cap Equity	26.2%	5.86%
U.S. Small Cap Equity	11.8%	6.56%
Global Equity	25.0%	6.85%
Domestic Fixed Income	28.0%	0.71%
Real Estate	9.0%	4.76%
Total	100.0%	

Discount Rate:

The discount rate used to measure the total pension liability was 7.25% as of June 30, 2014. The projection of cash flows used to determine the discount rate assumed plan member contributions will be made at the current contribution rate and that employer contributions will be made at rates equal to the actuarially determined contribution rates. For this purpose, only employer contributions that are intended to fund benefits of current plan members and their beneficiaries are included. Projected employer contributions that are intended to fund the service costs of future plan members and their beneficiaries, as well as projected contributions from future plan members, are not included. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments for current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability as of June 30, 2014.

Note 6: Net Pension Liability, continued:

Sensitivity of the Net Pension Liability to Changes in the Discount Rate:

The following presents the net pension liability of MCERA as of June 30, 2014, calculated using the discount rate of 7.25%, as well as what MCERA's net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (6.25%) or 1-percentage-point higher (8.25%) than the current rate:

	1% Decrease (6.25%)	Current Discount (7.25%)	1% Increase (8.25%)
Net pension liability	$ 219,678,759	$ 142,120,436	$ 78,313,271

Note 7: Reserves:

The Association had contingency reserves of $4,428,280, at June 30, 2014 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 7.25 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 position for pension and other benefits at June 30, 2014 (under the five-year smoothed asset valuation method for actuarial valuation purposes) is as follows:

Employee reserves	$ 55,711,672
Employer reserves	(47,773,613)
Retiree reserves	286,441,596
1% contingency reserves	4,428,280
Miscellaneous reserves	(75,849)
Total reserves	298,732,086
Cumulative unallocated net unrealized gain on investments	110,552,036
Total allocated reserves (smoothed actuarial value after corridor limits)	409,284,122
Net assets in excess of reserves	33,024,326
Net position held in trust for pension benefits	$ 442,308,448

Note 8: Other Income:

MCERA's actuary, Segal Consulting, determined that the employee basic contribution rate for fiscal years 2009-10, 2010-11, and 2011-12, as calculated by the Plan's prior actuary, was higher in the aggregate than it should have been. This resulted in a corresponding underpayment by employers during those same periods. MCERA worked with a team of professionals from 2011 to 2014 to establish the correct employee basic contribution rate, reimburse overpayments, and collect underpayments to the pension fund based on the corrected rates, and ensure the correction was in accordance with all tax laws and regulations. Corrected rates were in effect January 8, 2012, and the project was completed during the 2013-14 fiscal year.

MCERA entered into a settlement agreement with the prior actuary for an agreed upon amount which was deposited into a settlement reserve. After payment was made to all professionals working on the project to correct the error, a balance of $200,106 remained from the agreed upon settlement amount. The balance of $200,106 was transferred from a settlement reserve to the employer pension reserve during 2013-14 and recognized as other income during the year ended June 30, 2014.

Note 9: 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 decreased from $442 million to $436 million between July 1, 2014 and December 31, 2014. Capital markets continue to be highly volatile resulting in significant swings in market value, both positive and negative.

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 excess earnings postings were reviewed by tax counsel, an actuary and an accounting firm to develop findings and recommendations for submission to the IRS. A favorable determination letter and compliance statement was issued by the IRS to MCERA on January 29, 2014. MCERA worked with tax counsel to implement corrective actions and adopt appropriate model regulations. In line with the recommended actions, approximately $8.95 million were added to the UAAL and are being collected over the remaining 25 years of the UAAL amortization schedule, and the residual amount of excess earnings, totaling $658,654, previously classified as undesignated reserves, was credited to employer reserves as of June 30, 2014.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Required Supplementary Information (unaudited)
June 30, 2014

Schedules of Changes in Net Pension Liability and Related Ratios

	June 30, 2014	June 30, 2013
Total pension liability:		
Service cost	$ 11,762,194	$ 12,083,893
Interest	39,412,370	37,805,390
Change of benefit terms	-	-
Differences between expected and actual experience	(8,040,343)	(1,868,814)
Changes in assumptions	58,186,913	-
Benefit payments, including refunds of employee contributions	(27,353,529)	(26,573,554)
Net change in total pension liability	73,967,605	21,446,915
Total pension liability - beginning of year	510,461,279	489,014,364
Total pension liability - end of year (a)	$ 584,428,884	$ 510,461,279
Plan fiduciary net position:		
Contributions - employers'	$ 14,324,752	$ 14,260,473
Contributions - members'	4,575,895	4,712,593
Net investment income	68,294,844	48,890,492
Benefit payments, including refunds of employee contributions	(27,353,529)	(26,573,554)
Administrative expense	(930,437)	(829,999)
Other	200,106	-
Net change in plan fiduciary net position	59,111,631	40,460,005
Plan fiduciary net position - beginning of year	383,196,817	342,736,812
Plan fiduciary net position - end of year (b)	$ 442,308,448	$ 383,196,817
Net pension liability - end of year (a) - (b)	$ 142,120,436	$ 127,264,462
Plan fiduciary net position as a % of the total pension liability	75.7%	75.1%
Covered member payroll	$ 53,813,882	$ 53,254,876
Plan net pension liability as a % of covered member payroll	264.1%	239.0%

Trend Information: Schedules will ultimately show information for ten years. Additional years will be displayed as they become available prospectively.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Required Supplementary Information (unaudited)
June 30, 2014

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)
6/30/2007	$ 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%
6/30/2014	404,856	584,429	179,573	69.3%	55,876	321.4%

Schedule of Employer Contributions
(dollar amounts in thousands)

Year Ended	Annual Required Contribution	Percentage Contributed
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%
6/30/2014	14,325	100%