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

Financial Statements and Supplementary Information for the year ended June 30, 2012

GALLINA LLP
CERTIFIED PUBLIC ACCOUNTANTS

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, 2012

County Treasurer

Shari Schapmire, Vice Chairperson

Appointed by the Mendocino County Board of Supervisors

Bob Mirata, Chairperson

John Sakowicz, Trustee

Kendall Smith, Trustee

Ted Stephens, Trustee

Elected Members

Timothy J. Knudsen, Secretary

Randy Goodman, Trustee

Lloyd Weer, Trustee

Craig Walker, Trustee

Richard Shoemaker, Alternate Trustee

Administration

Rich White, Retirement Administrator

GALLINA LLP
CERTIFIED PUBLIC ACCOUNTANTS

Independent Auditor's Report

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

We have audited the accompanying statement of net assets available for benefits of Mendocino County Employees' Retirement Association (MCERA), a component unit of the County of Mendocino, as of June 30, 2012, and the related statement of changes in net assets available for benefits for the year then ended. These financial statements are the responsibility of MCERA's management. 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 includes consideration of internal control over financial reporting as a basis for designing 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 over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our 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, 2012, and the changes in its financial status for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis on pages 4 through 8, 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 29, 2013

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Management's Discussion and Analysis (unaudited)
June 30, 2012

The following section provides an overview and analysis of the Mendocino County Employees' Retirement Association (MCERA) financial activities for the year ended June 30, 2012. 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 Retirement Act of 1937 (Government Code Section 31450, et seq.) Pursuant to certain provisions of the County Retirement Act, 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 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 Mendocino County Courts and the Russian River Cemetery District.

Financial Highlights

Net assets available for benefits decreased to $342.7 million. This amount reflects a decrease of 3.46% in net assets during Fiscal Year 2011-12. Additions to plan assets for the fiscal year were $12.6 million. This was comprised of $11.8 million of employer contributions, $4.8 million of member contributions and a net investment loss of $4.0 million. Expenses (deductions in plan assets) for the year were $24.9 million which included $24.2 million in benefit payments to retirees and beneficiaries and $0.7 million in administrative expenses.

Budget

The Board approves MCERA's annual budget. The 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, which ever is greater. Previously, the limit was eighteen hundredths of one percent (0.18%) of MCERA's total assets. MCERA's administrative expense of $698,463, excluding IT costs of $210,118, represented 0.14% of MCERA's actuarial accrued liability or 34.92% of the $2 million statutory cap.

Overview of the Financial Statements

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 schedule pertaining to MCERA's Pension actuarial methods, assumptions, funded status and annual required contributions.

Management Responsibility of Financial Reporting

MCERA management is responsible 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:

- Negotiated a settlement agreement with the Association's former actuary for errors and omissions in prior reports and to finance the cost of correcting an error in employee contribution rates from July 2009 to January 2012.
- Significant progress was made in the project to determine the extent of overpayments or underpayments by members from July 2009 to January 2012, and to correct any errors in compliance with all Internal Revenue Service regulations.
- Engaged a new actuary to conduct a triennial experience study of economic and demographic assumptions, the recommendations of which were incorporated into the June 30, 2011 valuation study.
- The recruitment and selection process for a Retirement Administrator to succeed the current administrator who retired was completed on June 4, 2012.
- Implemented several new policies to bring the Association closer to best practices, including a cash management policy, Internal Revenue Service compliant retiree health care policy, overpayment collection policy, and placement agent policy.
- Engaged in a memorandum of understanding with the Assessor/Clerk Recorder for fiscal and accounting services.

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.

Investment returns in Fiscal Year 2011/12 fluctuated throughout the year along with the overall market conditions. The portfolio was down -1.04% for the fiscal year compared with the favorable returns in 2011 of 21.87%. Returns for the first quarter (2012) were 9.82% and for the second quarter were negative 3.19% reflecting the lost momentum in the economic recovery in the U.S.

Total portfolio returns were 11.35%, 2.09% and 5.63% for three, five and seven year periods ending June 30, 2012, respectively. These returns include periods during which MCERA recognized and posted excess earnings to the pension fund that were used to provide retiree health benefits. MCERA maintains an assumed net 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.

Investment and Economic Summary, continued

The economic climate on June 30, 2012 was summarized as "the best of a bad lot" in that the forecast for GDP growth in the United States in the 2% range actually looked 'stellar' compared to the prospects facing most of the globe's economies. First quarter (2012) GDP growth was revised down to 2% and the second quarter (2012) came in at a very subdued 1.5%. The U.S. equity markets could not maintain the swift pace set earlier in 2012 and the Russell 3000 Index (-3.15%) retreated. The general safety of U.S. Treasuries helped drive the U.S. Bond market. The Fed continued its low-rate policies. The non-U.S. Equity markets marched downward except for a small uptick in June, 2012.

Funded Status and Actuarial Reporting

MCERA maintains a funding goal to establish contributions that fully fund the Association'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 Association 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.

Mendocino County issued $31 million of pension obligation bonds in December 1996 and $76 million of pension obligation bonds in December 2002 to satisfy the Unfunded Accrued Actuarial Liability (UAAL) for the County, calculated as of that date.

In the June 30, 2012 valuation, the ratio of the actuarial value of assets to the actuarial accrued liabilities was 74.1% which was an increase from the prior year's valuation funded ratio of 73.6%. The Association's UAAL as of June 30, 2012 was $126,527,019. As of June 30, 2012, there are 27 years remaining in the declining 30-year amortization period of the UAAL.

The aggregate employer rate calculated in this valuation increased to 25.65% of payroll from 23.57% in last year's valuation. The aggregate employee rate increased to 9.76% of payroll from 9.73% in last year's valuation.

Awards and Achievements

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement of Excellence in Financial Reporting to MCERA for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2011. The Certificate of Achievement is the highest form of recognition in governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a government and its management.

Awards and Achievements, continued

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, whose contents conform to program standards. Such basic financial statements must satisfy both accounting principles generally accepted in the United States of America and legal requirements.

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, 2012

Assets

Investments, at fair value:		
Mutual funds		$ 333,396,451
Cash equivalents		2,354,860
Real estate partnership		6,362,464
Real estate - 625 Kings Court, Ukiah, CA		738,992
Total investments, at fair value		342,852,767
Receivables:		
Members' contributions	$ 75,196	
Employer contributions	204,466	
Total receivables		279,662
Other assets		3,786
Total assets		$ 343,136,215

Liabilities

Liabilities:		
Accounts payable	$ 142,052	
Accrued expenses and other liabilities	257,351	
Total liabilities		$ 399,403

Net Assets Available for Benefits

Net assets available for benefits	$ 342,736,812

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, 2012

Additions (deductions) to net assets attributed to:		
Investment income (loss):		
Net depreciation in fair value of investments		$ (11,133,208)
Rent income, net of expenses		45,644
Interest income		64,384
Dividend income		7,260,965
Investment expenses		(316,274)
Net investment loss		(4,078,489)
Contributions:		
Members'	$ 4,840,275	
Employer	11,811,076	
Total contributions		16,651,351
Total additions, net		12,572,862
Deductions from net assets attributed to:		
Benefits paid to retirees	24,180,110	
Administrative expenses	698,463	
Total deductions		24,878,573
Net decrease		(12,305,711)
Net assets available for benefits:		
Beginning of year		355,042,523
End of year		$ 342,736,812

See accompanying notes.

Note 1: Description of Plan:

Description of Association and Applicable Provisions of the Law:

The Mendocino County Employees' Retirement Association (MCERA 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. 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, 2012 consisted of the following:

Retirees and beneficiaries receiving benefits	1,217
Terminating plan members entitled to but not yet receiving benefits	356
Active plan members	1,069
Total	2,642
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 three 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. For 2012, the Board of Retirement approved a cost of living increase of 3.0%, depending on date of retirement, which became effective April 1, 2012.

Note 1: Description of Plan, continued:

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

Health benefits for retired employees have been funded by the Plan in the past. As of September 1, 1998, the County of Mendocino had assumed responsibility for partial funding of the cost of health care for the retired employees of the County of Mendocino, and will be responsible for the cost of health care when MCERA earnings on investments are not in excess of required transfers of earnings to retirement reserve accounts. On September 22, 2009, the Board of Supervisors adopted a superceding resolution which stated that retiree health care would only be paid from earnings in excess of transfers to the retirement reserve accounts or by the retirees in the form of a premium. For eligibility for health care coverage, prior to September 1, 1998, retirees must have served 10 years prior to retirement with the County of Mendocino, and retire as an active member. The retiree health benefit program qualifies under section 401(h) of the Internal Revenue Code. Health care payments to reimburse the County of Mendocino for the cost of retiree health care were formally made from a special reserve that has been established as a result of prior excess earnings. There were no health care subsidy amounts paid during the year ended June 30, 2012.

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.

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.

Note 2: Summary of Significant Accounting Policies, continued:

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, 2012 MCERA owned no derivatives directly in its portfolio.

Custodial Credit Risk:

Custodial risk for deposits in the Mendocino County trust 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 by MCERA's custodial bank in MCERA's name, or by other qualified third party administrator trust accounts.

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:

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%	23%
U.S. Fixed Income	23% - 33%	27%
Real Estate	4% - 14%	9%

Note 2: Summary of Significant Accounting Policies, continued:

Market and Credit Risk, continued:

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.

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.

Note 2: Summary of Significant Accounting Policies, continued:

Risk Management, continued:

The Mendocino County Department of Human Resources has assumed the duties of administering the health care claims of retirees. During the fiscal year ended June 30, 2011 MCERA came into full compliance with Internal Revenue Code Section 401(h) for any flow of funding.

Based on Mendocino County Board of Supervisors Resolution No. 98-147, County Counsel concluded that the County Board of Supervisors was ultimately responsible for the funding, administration and decision-making dealing with all aspects of the Plan. As a result, no incurred but not reported claims were included as liabilities on the financial statements for the year ended June 30, 2012. For the year ended June 30, 2012, MCERA had no excess earnings that can be used for the payment of retiree health benefits.

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.

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 29, 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 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.

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 the 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.

Note 3: Investments, continued:

The Association's cash and investments stated at fair value as of June 30, 2012, are as follows:

Cash in trust - Mendocino County	$ 2,354,860
Total cash equivalents	2,354,860
U.S. Government and corporate bonds	92,893,393
International equities	77,140,774
Domestic equities - small cap	21,518,466
Domestic equities - mid cap	21,744,297
Domestic equities - large cap	96,725,492
Real estate	23,374,029
Total mutual funds	333,396,451
Real estate partnership	6,362,464
Real estate - 625 Kings Court, Ukiah, CA	738,992
Total investments	$ 342,852,767

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, 2012.

Mutual funds and real estate partnership: Valued at the net asset value of shares held by the Plan at year end.

Real estate – 625 Kings Court, Ukiah, CA: Valued at cost, which approximates 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.

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, 2012:

	Investments at Fair Value as of June 30, 2012			
	Level 1	Level 2	Level 3	Total
Mutual funds:				
Bond funds	$ 92,893,393	$ -	$ -	$ 92,893,393
International securities	77,140,774	-	-	77,140,774
Domestic securities	139,988,255	-	-	139,988,255
Real estate	23,374,029	-	-	23,374,029
Total mutual funds	333,396,451	-	-	333,396,451
Real estate partnership	6,362,464	-	-	6,362,464
Real estate - 625 Kings Court, Ukiah, CA	-	-	738,992	738,992
Total investments at fair value	$ 339,758,915	$ -	$ 738,992	$ 340,497,907

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, 2012 as follows:

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

Note 5: Contributions:

The actuarially determined member contribution rates payable for fiscal year 2013-14 average 9.76 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 2013-14, employers are also required to contribute an actuarially determined rate of 25.65 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 County of Mendocino 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 County of Mendocino 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 County was 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 County of Mendocino must amortize the UAAL over a 30-year period from June, 2009.

For the actuarial valuation for the year ended June 30, 2010, the prior actuary changed their assumptions regarding withdrawals by inactive members. This change in assumption affected the projected number of inactive members who would withdraw their contributions and forego a retirement, compared to those who would leave their contributions and vested benefits with the Plan and retire at a later date. The result was an estimated increase of $3.3 million in the County's contribution for the fiscal year ended June 30, 2012.

The UAAL as of June 30, 2012 is $126.5 million, which the County of Mendocino is required to amortize in the future. The funded ratio at June 30, 2012 is 74.1%, as indicated on the Schedule of Funding Progress on Page 24. The *Actuarial Valuation and Review* report issued by The Segal Company as of June 30, 2012 recommended employer and member contribution rates that aggregate to 25.65% and 9.76%, 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, 2012
Actuarial cost method	Entry age normal cost method (individual basis)
Amortization method	Level % of payroll for total unfunded liability
Remaining amortization period	27 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% + 0.50% across-the-board salary 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, 2010 actuarial valuation, management has estimated the contributions are comprised of the following for the year ended June 30, 2012:

Estimated employer normal cost contributions	$	6,859,383
Estimated UAAL contributions		4,951,693
Total	$	11,811,076

Note 6: Reserves:

The Association had contingency reserves of $3,550,728, at June 30, 2012 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, 2012 (under the five-year smoothed asset valuation method for actuarial valuation purposes) is as follows:

Employee reserves	$ 62,997,613	
Employer reserves	(35,311,033)	
Retiree reserves	270,972,746	
Undesignated reserves (Note 7)	658,654	
1% contingency reserves	3,550,728	*
Settlement reserve	248,093	
Miscellaneous reserves	9,259	
Total reserves	303,126,060	
Cumulative unallocated net unrealized gain on investments	62,792,624	
Total allocated reserves (smoothed actuarial value after corridor limits)	365,918,684	
Net assets in excess (deficit of reserves)	(23,181,872)	
Net assets held in trust of pension benefits	$ 342,736,812	

* Based on their June 30, 2012 valuation, Segal reported a 1% contingency reserve of $3,431,339.

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 $343 million to $357 million between July 1, 2012 and December 31, 2012. 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 (Segal), 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 will be in effect January 8, 2012, and the project is expected to be completed before the end of fiscal year 2012-13.

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, 2012. 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 2013.

Mendocino County Employees' Retirement Association
(A Component Unit of the County of Mendocino)
Required Supplementary Information (unaudited)
June 30, 2012

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)
6/30/2005	$ 253,487	$ 289,467	$ 35,980	87.6%	$ 57,664	62.4%
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%

Schedule of Employer Contributions
(dollar amounts in thousands)

Year Ended	Annual Required Contribution	Percentage Contributed
6/30/2005	$ 3,221	47%
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%