



**AGENDA ITEM 4: APPROVAL OF DELEGATED AUTHORITY TO AUDIT CHAIR  
RELATED TO NON-AUDIT SERVICES OF EXTERNAL AUDITORS**

General Counsel and Corporate Secretary Carol R. Newman was requested to discuss the NAIC Model Audit Rule (MAR) requirements applicable to State Fund's current and contemplated use of its external auditors, KPMG LLP, to perform contract compliance audits for collection agencies under contract with State Fund in 2010 and to introduce a Resolution regarding such use. Ms. Newman explained that State Fund may retain KPMG LLP to perform non-audit services that do not impair KPMB LLP's independence or are not prohibited by MAR. Under MAR the Audit Committee may directly approve or delegate authority to a Committee member to preapprove an engagement for such non-audit functions and report the preapproval to the full Committee at the next scheduled meeting. Ms. Newman noted that to expedite the work Mr. Quinlan preapproved KPMG LLP's performance of one compliance audit requiring ratification by the Audit Committee, and approval of additional KPMG LLP compliance audit services was sought, as well as the delegation of preapproval authority to the Committee Chair in order to facilitate handling future requests for non-audit services.

Ms. Newman read the proposed resolution.

MOTION: Mr. Zachry

Second: Mr. Rank

To delegate, pursuant to the NAIC Model Audit Rule, preapproval authority for performance of audit or non-audit functions by State Fund's independent auditors to the Committee Chair and the Chair shall present any such preapproval decisions to the Committee at its next schedule meeting;

To approve the retention of KPMC LLP to perform contract compliance audits in connection with the Contract Agreements between the State Fund and seven collection services under contract with State Fund in 2010, for an amount not to exceed \$150,000 is approved; and

To ratify and approve the prior approval by the Chair of this Committee of the retention of KPMG LLP to perform a similar contract compliance audit in connection with the Contract Agreement between a collection service and State Fund, for an amount not to exceed \$75,000.

Mr. Quinlan requested Committee discussion and public comment of which there were none. Mr. Quinlan called for the vote.

YES: 3

NO: 0

Motion carried.

**AGENDA ITEM 5: OVERVIEW OF KPMG LLP'S SYSTEM OF QUALITY CONTROLS**

Mr. Quinlan invited Leigh Wilson, KPMG LLP's Engagement Auditor leading the external financial audit, to report on KPMG LLP's system of quality controls.

Ms. Wilson explained that KPMG LLP has robust audit quality control processes incorporating such elements as engagement partner rotation requirements under applicable independence rules, internal testing to monitor compliance with firm policies, review and identification of client risks, rigorous personnel management systems to determine requisite capabilities and competencies for audit teams, professional training, development and annual performance reviews, as well as strong client engagement acceptance and continuance policies.

Ms. Wilson further advised that KPMG LLP and its audit quality controls are subject to review by the Public Company Accounting Oversight Board (PCAOB), which conducts periodic inspections of registered firms. PCAOB inspection reports regarding KPMG LLP for 2007 and 2008, issued in 2008 and 2009 respectively, are located on its website and include both public and non-public portions. KPMG also conducts an annual internal review of its auditing practice through its Quality Performance and Compliance Program (QPCP). The 2010 inspection report contained no material findings regarding KPMG LLP audit practices.

Ms. Wilson also explained that KPMG LLP participates in annual peer review performed by PricewaterhouseCoopers LLP (PwC). KPMG LLP received a peer review pass rating with respect to its dedicated audit quality functions. Ms. Wilson reported that KPMG is not aware of any governmental inquiry regarding the firm or its partners with any adverse material affect or that has resulted in revision to KPMG LLP's audit quality control procedures.

**AGENDA ITEM 6: COMPLETED CLOSED AUDITS**

Mr. Quinlan invited Marie W. Wardell, Internal Audit Manager, to report on closed audits.

**PAO 590 - Accounts Payable/General Ledger Audit**

Ms. Wardell explained that Internal Audit evaluated internal controls over adjustments to ledger accounts, invoice management and payment processing, and accruals. Testing included invoices processed and ledger accounts posted from January 2010 to June 2010, and accruals performed in the second quarter of 2010. The audit concluded that internal controls were adequate to achieve business objectives, although a lack of segregation of duties was identified where two supervisors in the Payable/Receivables Service Unit both could approve payments in Oracle AP and post journal entries into Oracle GL, which created the potential for fraud as the supervisors would approve payments which then could be altered in the general ledger. This issue was remediated in December 2010 by removing the supervisors' ability to approve payments in Oracle AP.

There was discussion about the need for employee training concerning the purpose of accounting checks and balances to eliminate the possibility of such issues occurring in the future.

#### **PAO 538 - Procurement Function Audit**

Ms. Wardell reported that in 2008 Internal Audit initiated an evaluation of the I-Procurement system focusing on purchase transactions processed between 10/1/05 and 10/1/07. The 2008 testing sample suggested ledger account changes without notification to the approving unit; missing payment support documentation; lack of vendor performance tracking and analysis; and employees not being required to file Statements of Economic Interests (SEI). The 2008 data was rendered obsolete as a result of State Fund's implementing new procurement processes and procedures, and Internal Audit re-tested using transactions occurring between 1/1/10 and 6/30/10. The 2010 samples did not reveal any of the same issues. Additionally, the number of State Fund employees required to file SEI in March 2010 was expanded and Internal Audit verified employee compliance. Complete remediation is targeted for 5/1/11 when Contracts and Purchasing implements a Contract Lifecycle Management System (CLMS) for vendor tracking and analysis.

There was discussion regarding the need for clear procurement controls and routine monitoring to identify and rectify any actual or potential conflicts of interest.

#### **AGENDA ITEM 7: AUDIT COMMITTEE CHARTER**

Mr. Quinlan reported that the annual reassessment of the Audit Committee Charter was in progress. There being no objection, consideration of a new Audit Committee Charter was deferred to the May 12, 2011 meeting of the Committee.

#### **AGENDA ITEM 8: REVISED INTERNAL AUDIT CHARTER & COMPLIANCE WITH INSTITUTE OF INTERNAL AUDITOR (IIA) STANDARDS**

Mr. Quinlan requested Marie W. Wardell, Internal Audit Manager, to report on proposed revisions to the Internal Audit Activities Charter.

Ms. Wardell explained that IIA recommended review of the Internal Audit Activities Charter to assure its continuing relevance and alignment with organizational objectives. The proposed revised Internal Audit Activities Charter is written to be customized to State Fund and to clearly reflect the IIA framework and mission. The Internal Audit Activities Charter clarifies that Enterprise Risk Management activities are related to evaluating the controls instituted to mitigate an enterprise risk, and that Internal Audit continues to be responsible for fraud investigations related to State Fund's employees. There were no comments regarding the revisions and the revised Internal Audit Activity Charter will be posted to the Internal Audit worksite.

Mr. Quinlan reported that Audit Committee alternate, James Richardson, submitted his letter of resignation to the Board of Directors, because his company, The Dentists

Insurance Company, was moving into the workers' compensation insurance market. Mr. Quinlan commended the prudent proactive action to avoid the possibility of even the appearance of a conflict of interest and extended his thanks to Mr. Richardson, in absentia, for his service.

Mr. Quinlan requested Committee discussion and public comment of which there were none.

**AGENDA ITEM 9: PUBLIC COMMENT ON APPROPRIATENESS OF CLOSED SESSION FOR ITEMS 12 THROUGH 15**

Mr. Quinlan requested public comment on the appropriateness of Closed Session Agenda Items 12-15.

Mr. Randall F. Cheek, Legislative Advocate, SEIU Local 1000, questioned the inclusion of Agenda Item 14-Specialized Audit Training/Co-Sourcing and Item 15-Anti-Fraud Strategy in closed session. Ms. Kathleen B. Collins, Vice President of Bargaining, SEIU Local 1000, observed that the in progress Fraud Unit Optimization Review raised concerns that co-sourcing meant out-sourcing jobs.

Mr. Quinlan requested Ms. Newman explain the agenda items identified for closed session. General Counsel Carol R. Newman explained that discussions with respect to Agenda Item 14 regarding personnel and staffing issues are confidential, and discussions regarding future audit plans could potentially expose the organization to security risks. Ms. Newman clarified that co-sourcing related to obtaining appropriate consulting assistance to train auditing personnel and improve audit quality. Mr. Quinlan noted that co-sourcing would improve State Fund's ability to effectively work with District Attorneys on fraud referrals. With respect to Agenda Item 15, Ms. Newman noted that State Fund actively pursues fraud and does not want to signal its anti-fraud strategy and action plans.

**AGENDA ITEM 10: PUBLIC COMMENT**

Mr. Quinlan requested public comment of which there was none. The Audit Committee immediately convened into Closed Session at 8:30 a.m.

**AGENDA ITEM 16: CALL TO ORDER AND ROLL CALL**

The meeting reconvened at 9:55 a.m. following the conclusion of the Closed Session and the following Members were present: Francis (Frank) E. Quinlan, Steven L. Rank, and William M. Zachry.

Also present: President and Chief Executive Officer Tom Rowe; Internal Audit Manager and Secretary Pro-Tem Marie W. Wardell; Edward A. Nielsen; Chief Risk Officer Ken Van Laar; and Chief Financial Officer Dan Sevilla.

There was a quorum.

**AGENDA ITEM 17: COMMITTEE MEMBER PRESENTATIONS**

Mr. Quinlan asked if there were any Committee Member presentations of which there were none. There was discussion about the industry-wide need to focus attention on effectively combating fraud.

**AGENDA ITEM 18: PROPOSALS AND SUGGESTIONS FOR MAY 12, 2011 AGENDA**

Mr. Quinlan requested proposals and suggestions for the May 2011 agenda and public comment. It was suggested that the Committee receive monthly reports from the Special Investigation Unit (SIU), and that Maryann T. Lazernik, SIU Program Manager, be invited periodically to provide an anti-fraud progress report. There was no public comment.

The next Audit Committee meeting is scheduled for May 12, 2011 at 8:00 a.m. in San Francisco, California.

**ADJOURNMENT**

There being no further business before the Audit Committee, the meeting adjourned at 10:05 a.m.

Respectfully submitted,

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Vera C. De Martini  
Assistant Corporate Secretary