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Date: November 1, 2013

TO: MEMBERS, BOARD OF DIRECTORS

I. AGENDA ITEM # AND TITLE :	Open Agenda Item 6 – Report of External Auditor: KPMG 2013 Audit Plan
II. NAME AND PROGRAM:	KPMG – External Audit
III. ACTIVITY:	<input checked="" type="checkbox"/> Informational <input type="checkbox"/> Request for Direction <input type="checkbox"/> Action Proposed
IV. JUSTIFICATION:	<input checked="" type="checkbox"/> Standard/Required Item <input type="checkbox"/> Board Request – New Item <input type="checkbox"/> New Topic from Staff

V. EXECUTIVE SUMMARY:

To present KPMG’s Audit Plan for State Fund’s 2013 Statutory Financial Statements. Key talking points – KPMG client service team and key auditing and accounting matters for State Fund in 2013.

VI. ANALYSIS:

Overall, KPMG’s team will be fairly consistent with prior year. Lindsay Brusco will be replacing Julie Rhodes Urrea as audit senior manager since Julie has transferred to our Advisory Practice. Lindsay served as senior manager for the 2011 audit of State Fund, specializes in insurance and is experienced with California workers’ compensation. Jennifer Austin will be the concurring review partner (recently transferred to the San Francisco office from our National Office and specializes in insurance). A key area of focus for the 2013 audit in addition to loss and loss adjustment expense reserving is the impact(s) related to tiered pricing.

VII. RECOMMENDATION:

We recommend the Audit Committee review KPMG’s 2013 Audit Plan.

VIII. PRESENTATION EXHIBITS:

Includes the 2013 Audit Plan

IX. APPENDIX I and II:

Substantive Testing Approach and Selected Other Information



cutting through complexity

**State Compensation Insurance Fund
Audit Committee – November 13, 2013
Open Agenda Item 6 – Report of External Auditor**

**Audit Plan
December 31, 2013**

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Agenda

Client service team

Scope/Key Deliverables

Summary of Key Auditing and Accounting Matters for 2013

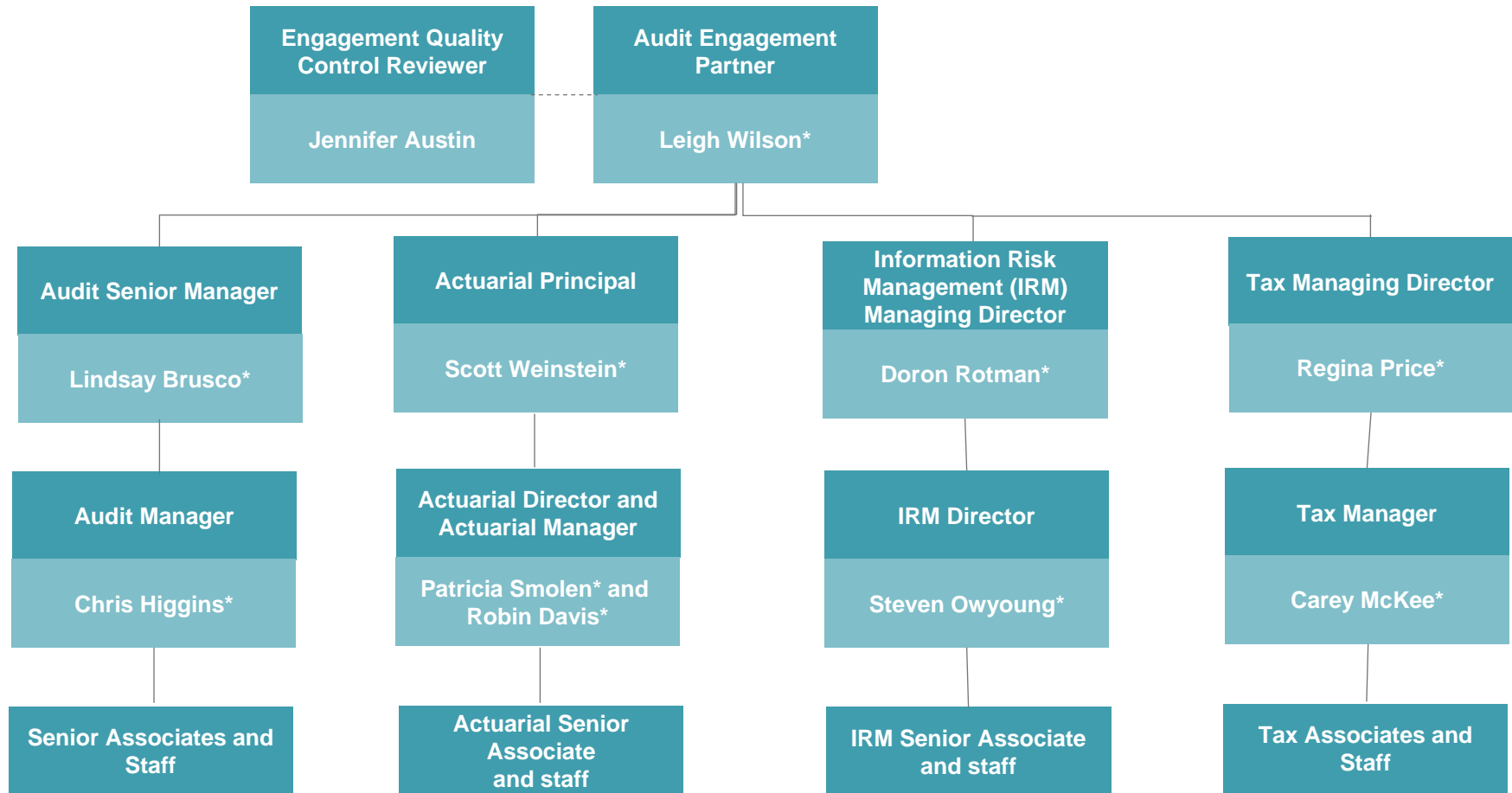
Appendix I

- **Substantive Testing Approach for Key Risks**
- **Consideration of Fraud Risks**

Appendix II

- **Objective of an Audit**
- **Responsibilities**
- **KPMG's audit approach and methodology**
- **Materiality**
- **Auditing and accounting matters to be discussed with the Audit Committee**
- **Regulatory, Accounting, and Emerging Issues Update**
- **Independence**
- **KPMG's Audit Committee Institute**
- **KPMG Ethics and Compliance Hotline**

Client Service Team



** Individuals with prior experience as members of the State Compensation Insurance Fund Client Service Team*

Summary of Key Auditing and Accounting Matters for 2013

Key audit areas/estimates/considerations		Significant unusual transactions/other items	Information technology matters
<ul style="list-style-type: none"> ■ Valuation of loss and loss adjustment expense reserves ■ Valuation of State Fund's portion of the pension and other postemployment benefit obligation ■ Valuation of investments ■ Valuation of reinsurance recoverables ■ Existence of premiums 	<p>2013 Key Related Areas:</p> <ul style="list-style-type: none"> ■ Changes to underwriting tools and procedures (i.e. implementation of Tiered Pricing) ■ Impact of Senate Bill 863 ■ Investment strategies – equity securities ■ Substantial increase in new business 	<ul style="list-style-type: none"> ■ KPMG plans to review significant, non-routine transactions occurring in 2013, such as: <ul style="list-style-type: none"> - Changes to underwriting tools and procedures (i.e. implementation of Tiered Pricing) - Related party transactions (if any) - Litigation and regulatory matters (including ongoing examination) - Implementation of new accounting pronouncements and auditing standards 	<ul style="list-style-type: none"> ■ General information technology environment ■ New and continuous systems implementation <ul style="list-style-type: none"> - Implementation of Tiered Pricing

Appendix I:

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Substantive Testing Approach – Key Risks

Audit Area	Selected Audit Procedures
<p>Estimated Liabilities for Loss and Loss Adjustment Expense</p>	<ul style="list-style-type: none"> ● Obtain an understanding of significant changes in pricing, underwriting, claims settlement practices, legal and legislative environment (tiered pricing, premium increases) and similar factors, and assess impact on loss reserve estimates ● Assess Company's methodology for evaluating adequacy of reserves and reasonableness and compliance with actuarial standards ● Assess accuracy of data within the claims systems by testing a sample of claim files ● Engage KPMG Actuary to perform independent analysis of loss reserves and review the Company's loss and loss adjustment expense reserve analysis ● Assess completeness and accuracy of the underlying data used by the Company's actuaries in determining IBNR by agreeing data to underlying records for a selected number of claim files and other data ● Reconcile claims paid to banking records ● Assess appropriateness of financial statement disclosures

Substantive Testing Approach – Key Risks (cont'd)

Audit Area	Selected Audit Procedures
Investments (including valuation of investments)	<ul style="list-style-type: none"> ● Understand Company's approach to pricing investment securities ● Perform independent price testing and impairment analysis with particular focus on credit markets disruption and impact on investment portfolio ● Confirm existence and ownership ● Perform test of details over investment income ● Assess appropriateness of relevant financial statement disclosures
Reinsurance (including valuation of reinsurance recoverables)	<ul style="list-style-type: none"> ● Read all significant contracts and evaluate for compliance with applicable accounting pronouncements (e.g. risk transfer vs. deposit accounting) ● Review the Company's methodology for assessing the collectability of recoverables ● Recalculate ceded balances and reinsurance recoverable ● Review the Company's accounting for the Catastrophe bond coverage ● Confirm terms of significant reinsurance contracts and related collateral ● Recalculate the recorded recoverable of the Loss Portfolio Transfer ● Assess appropriateness of financial statement disclosures

Substantive Testing Approach – Key Risks (cont'd)

Audit Area	Selected Audit Procedures
<p>Existence of premiums (including estimated Earned but Unbilled Premiums)</p>	<ul style="list-style-type: none"> ● Assess accuracy of data within the underwriting systems by testing a sample of policy files ● Reconcile premium cash receipts to banking records ● Assess the reasonableness and appropriateness of policies used by the Company to determine earned but unbilled premium (EBUB) ● KPMG Actuary to review Company's actuarial analysis of EBUB ● Test propriety of unearned premium calculations ● Assess appropriateness of the allowance for premium receivable ● Assess calculation and collectability of guaranty fund receivables ● Assess appropriateness of financial statement disclosures

Substantive Testing Approach – Key Risks (cont'd)

Audit Area	Selected Audit Procedures
Estimate of State Fund's portion of the pension and other postemployment benefit obligation	<ul style="list-style-type: none">● Obtain an understanding of significant changes in the Company's determination of the estimate of the unfunded liability● Assess Company's methodology and any third party documentation for evaluating adequacy of the unfunded liability● Obtain an understanding of the Company's process to come up with a range to estimate the total contingency● Assess appropriateness of financial statement disclosures

Substantive Testing Approach – Key Risks (cont'd)

Audit Area	Selected Audit Procedures
Regulatory/Litigation matters and valuation of related reserves	<ul style="list-style-type: none"> ● Confirm the status and expected outcome of significant litigation with external counsel ● Review any identified cases for potential accrual or disclosure ● Review emerging and ongoing regulatory and legislative issues with general counsel and assess for any potential accounting impact ● Assess appropriateness of financial statement disclosures
General IT Controls (“GITC”)	<ul style="list-style-type: none"> ● Key areas of GITC testing include system access, program changes, program development, computer operations and other changes including tiered pricing implementation ● Test the access to in-scope applications and the underlying databases ● Ensure developer segregation of duties and emergency change control is in place ● Review Company’s assessment of the recoverability of financial data and test the Company’s job monitoring process ● Testing for program development is aimed at projects that have financial significance to the Company and its infrastructure ● Obtain an understanding of on-going IT transformation and any impact to current year audit

Consideration of Fraud Risks

Required Consideration of fraud risks:

- Perform risk assessment procedures to identify fraud risks, both at the financial statement level and at the assertion level
- Discuss among the engagement team the susceptibility of the entity to fraud
- Perform fraud inquiries of management, the Audit Committee and others
- Evaluate the Company's broad programs/controls that prevent, deter, and detect fraud

Fraud Risks Identified in Planning (Consistent with Prior Years and Common with P&C Insurers)

- Loss and loss adjustment expense reserves, due to materiality and subjectivity of estimates
- Risk of management override of controls
 - Top-side journal entries and adjustments
 - Significant accounting estimates
 - Significant unusual transactions, if any

Our audit procedures related to fraud risks include:

- | | |
|--|---|
| <ul style="list-style-type: none"> ■ Conduct interviews in accordance with AICPA AU-C 240, <i>Consideration of Fraud in a Financial Statement Audit</i> ■ Evaluate of risk of management override of controls - Inquire of management and key process and control owners as to management override. ■ Evaluate design and implementation and test the operating effectiveness of certain anti-fraud controls ■ Perform testwork over journal entries and adjustments ■ Perform specific substantive audit procedures (incorporate elements of unpredictability) ■ Review support for significant estimates and discuss rationale with management | <ul style="list-style-type: none"> ■ Evaluate the reasons for any key changes such as significant movements within the actuarial ranges, significant differences between carried reserves and internal and external actuaries' estimates, and analysis of developments from prior period estimates. ■ Obtain KPMG actuarial review of loss reserves and evaluate significant differences from carried reserves. ■ Reconcile premium cash receipts and claims paid to banking records ■ Review significant, unusual transactions – as applicable ■ Communicate with the Audit Committee |
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Selected Other Information – Objective of an audit

- The objective of an audit of financial statements is to enable the auditor to express an opinion about whether the financial statements that have been prepared by management with the oversight of the Audit Committee are presented fairly, in all material respects, in conformity with statutory accounting principles (or in conformity with the instructions of the California State Controller’s Office).
- We plan and perform the audit to obtain reasonable assurance about whether the financial statements taken as a whole are free from material misstatement, whether from error or fraud. Although not absolute assurance, reasonable assurance is a high level of assurance
- Our audit includes:
 - Performing tests of the accounting records and such other procedures, as we consider necessary in the circumstances, based on our judgment, including the assessment of the risks of material misstatement to provide a reasonable basis for our opinion.
 - Evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, and evaluating the overall financial statement presentation.

Selected Other Information – Responsibilities

Management is responsible for:

- Adopting sound accounting policies
- Fairly presenting the financial statements in conformity with statutory accounting principles prescribed or permitted by the California Department of Insurance (or in conformity with the instructions of the California State Controller's Office)
- Establishing and maintaining effective internal control over financial reporting (ICFR)
- Identifying and confirming that the Company complies with laws and regulations applicable to its activities
- Making all financial records and related information available to the auditor
- Providing unrestricted access to person's within the entity from whom the auditor determines it necessary to obtain audit evidence
- Providing the auditor with a letter confirming certain representations made during the audit that include, but are not limited to, management's:
 - Disclosure of all significant deficiencies, including material weaknesses, in the design or operation of ICFR that could adversely affect the Company's ability to initiate, authorize, record, process, or report financial data
 - Acknowledgement of their responsibility for the design and implementation of programs and controls to prevent, deter, and detect fraud
 - Responsibility for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Additional NAIC Model Audit Rule (MAR) Management Responsibilities:

- Designate an Audit Committee
- Accept responsibility for establishing and maintaining adequate ICFR
- Identify framework used to evaluate ICFR
- Present written assessment regarding effectiveness of ICFR, including disclosure of any material weaknesses identified by management

Selected Other Information – Responsibilities (continued)

The Audit Committee is responsible for:

- Oversight of the financial reporting process and oversight of ICFR
- Oversight of the establishment and maintenance by management of programs and internal controls designed to prevent and detect fraud

Management and the Audit Committee are responsible for:

- Setting the proper tone and creating and maintaining a culture of honesty and high ethical standards

The audit of the financial statements does not relieve management or the Audit Committee of their responsibilities.

Selected Other Information – Responsibilities (continued)

KPMG LLP (KPMG) is responsible for:

- Forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are prepared, in all material respects, in accordance with the applicable financial reporting framework
- Planning and performing the audit with an attitude of professional skepticism
- Conducting the audit in accordance with professional standards and complying with the Code of Professional Conduct of the American Institute of Certified Public Accountants, and the ethical standards of relevant CPA societies and relevant state boards of accountancy
- Evaluating ICFR as a basis for designing audit procedures, but not for the purpose of expressing an opinion on the effectiveness of the entity's ICFR
- Communicating to management and the Audit Committee all required information, including significant matters
- Communicating to the Audit Committee and management in writing all significant deficiencies and material weaknesses in internal control identified in the audit and reporting to management all deficiencies noted during our audit that are of sufficient importance to merit management's attention

Selected Other Information – KPMG’s audit approach and methodology

1. Experienced team

We have an experienced team.

Our team includes the following specialists:
Information Technology and Actuarial.

6. Compliance with applicable professional standards

KPMG has systems and processes in place to monitor compliance with professional standards.

5. Consistent audit methodology worldwide

Consistent audit methodology and technology used by KPMG member firms worldwide.



2. Tailored to State Fund’s business strategies and activities

In developing our audit plan for 2013, we have based our approach on our understanding of State Fund’s objectives and strategies and the challenges facing the business in 2013.

3. Top-down, risk-based approach

We work closely with management to understand the business challenges and changes in the business during the year with respect to the impact on our audit approach.

Our audit plan outlines our assessment of audit risk and highlights specific areas of focus for 2013.

4. Effective and efficient audit

Our audit approach involves interaction with all levels of management throughout the year to identify issues.

Our audit approach is based on communication and coordination with management and Internal Audit.

Selected Other Information – KPMG’s audit approach and methodology (continued)

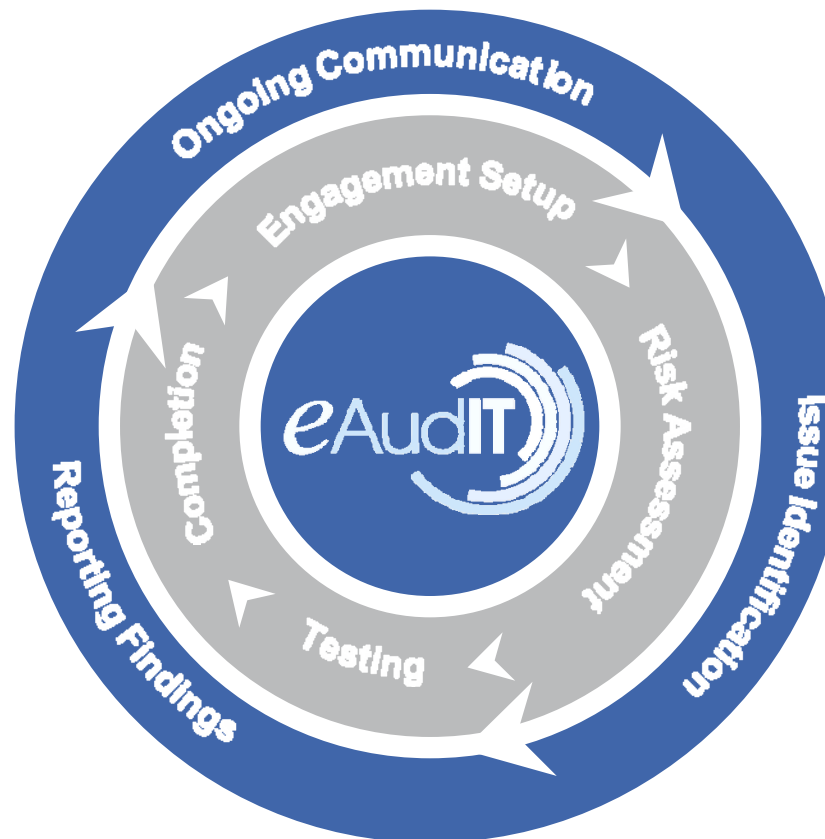
Technology enabled audit work flow

Engagement Setup

- Tailor the eAudit work flow to your circumstances
- Access global knowledge specific to your industry

Completion

- Form and issue audit opinion on financial statements
- Required communications to those charged with governance
- Debrief audit process



Risk Assessment

- Understand your business and financial processes
- Identify significant risks
- Determine audit approach
- Evaluate design and implementation of your internal controls

Testing

- Test effectiveness of your internal controls
- Perform substantive tests

Selected Other Information – Materiality

- Professional standards require that we exercise professional judgment when we consider materiality and its relationship with audit risk when determining the nature, timing, and extent of our audit procedures, and when evaluating the effect of misstatements.
- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- Materiality depends on the size and nature of the item or error judged in the particular circumstances of its omission or misstatement.
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Selected Other Information – Auditing and accounting matters to be discussed with the Audit Committee

Other matters for discussion with the Audit Committee include their views about:

- The appropriate person (Audit Committee Chair or full committee) for communication of audit matters during the audit
- Allocation of responsibilities between management and the Audit Committee
- Entity's objectives and strategies and related business risks
- Areas that warrant particular attention during the audit and additional procedures to be undertaken
- The nature and extent of communications expected with the Audit Committee about misappropriations perpetrated by lower-level employees
- Significant communications with the regulators
- The attitudes, awareness, and actions concerning (a) the entity's internal controls and its importance in the entity, including oversight of effectiveness of internal controls, and (b) detection of or possibility of fraud
- The actions in response to developments in law, accounting standards, corporate governance, and other related matters
- Actions in responses to previous communications with the auditor

Selected Other Information – Regulatory, Accounting, and Emerging Issues Update

New or Proposed Pronouncement/Regulation

NAIC Model Law: *Risk Management and Own Risk and Solvency Assessment (ORSA) Model Act* :

Groups within the NAIC developed a model law requiring insurers to report annually to regulators on their organizational risk and solvency assessments. During the Fall 2012 NAIC Meeting, the Act was adopted with an ORSA Guidance Manual adopted at the Spring 2013 NAIC Meeting. Currently, state legislatures have 2013 and 2014 to adopt the Act prior to the expected effective date of January 1, 2015.

FASB: Proposed Accounting Standards Update, *Insurance Contracts*, June 27, 2013

In June 2013, the FASB issued a proposed Accounting Standards Update (ASU) that would change the accounting and financial reporting for insurance and reinsurance contracts issued and reinsurance contracts held regardless of the type of entity issuing or holding the contract. The FASB has jointly deliberated the insurance contracts proposals with the IASB, which recently issued a re-exposure of its proposals .

The proposed ASU introduces a building block approach (based on discounted estimates of future cash flows under the contract and a margin to remove any gain at inception) to account for most life, annuity, and long-term health contracts and a premium allocation approach (comprising a liability for the remaining coverage under the contract and a liability for incurred claims) for most property and casualty and short-term health contracts. These approaches would replace the numerous accounting models that were developed in U.S. GAAP to address specific types of insurance contracts.

The proposed ASU would require retrospective application and would prohibit early adoption. It does not specify an effective date, but requests feedback on an appropriate effective date. The proposed ASU indicates that the effective date for nonpublic entities will likely be a minimum of one year after the effective date for public entities.

Independence

Non-audit services or other relationships that may reasonably be thought to bear on independence include:

- None noted.

In our professional judgment, we are independent with respect to State Compensation Insurance Fund, as that term is defined by the professional standards.

KPMG's Audit Committee Institute (ACI)

Communicating with audit committees since 1999

Upcoming events

- Ongoing: Audit Committee Webcasts
 - A quarterly Webcast providing updates and insights into issues affecting audit committee/board oversight—from key accounting and regulatory changes to developments in risk oversight. Visit www.kpmg.com/aci to register.

Resources

- *Audit Committee Insights* – U.S. and International editions (biweekly electronic publications): www.kpmginsights.com
- ACI Web site: www.auditcommitteeinstitute.com
- ACI mailbox: auditcommittee@kpmg.com
- ACI hotline: 1-877-KPMG-ACI

KPMG Ethics and Compliance Hotline

www.kpmgethics.com and 1-877-576-4033

Purpose – To provide a confidential, non-retaliatory, and anonymous hotline for the good faith reporting of concerns about possible violations of law, professional and ethical standards, and KPMG policy.

Scope – The Hotline is available to all firm partners and employees, as well as clients, contractors, vendors, and others in a business relationship with KPMG, including other KPMG member firms whose partners and employees may be working with the U.S. firm on engagements with U.S. clients.

Firm Ombudsman – All reports related to SEC audit clients will be directed to the firm's Ombudsman for investigation and resolution.



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