



cutting through complexity

State Compensation Insurance Fund Audit Plan December 31, 2012

Open Agenda Item 5 – Report of External Auditor: 2012 Audit Plan

This presentation to the Audit Committee is intended solely for the information and use of the Audit Committee and management and is not intended to be and should not be used by anyone other than these specified parties. This presentation is not intended for general use, circulation or publication and should not be published, circulated, reproduced or used for any purpose without our prior written permission in each specific instance.

State Compensation Insurance Fund – Audit Committee Meeting
November 14, 2012 (OPEN SESSION MATERIALS)

Letter to the Audit Committee

Open Session Materials

November 14, 2012

Audit Committee of State Compensation Insurance Fund,

We are pleased to submit our audit plan for State Compensation Insurance Fund as of and for the year ending December 31, 2012.

Each year we strive to enhance the quality and execution of our audit approach in order to continue to deliver the highest quality audits. This audit plan has been developed based on debriefings of the prior year's audits and considers changes within the State Compensation Insurance Fund organization as well as developments in audit and accounting regulations. We continue to focus our audit activities on higher risk areas involving significant management judgment.

Our 2012 audit plan describes our audit team, key audit activities and deliverables, and our planned approach to critical and significant audit areas and the risks identified therein. I look forward to discussing our approach with you and welcome your input.

Very truly yours,
KPMG LLP

Leigh Wilson
Partner

Agenda

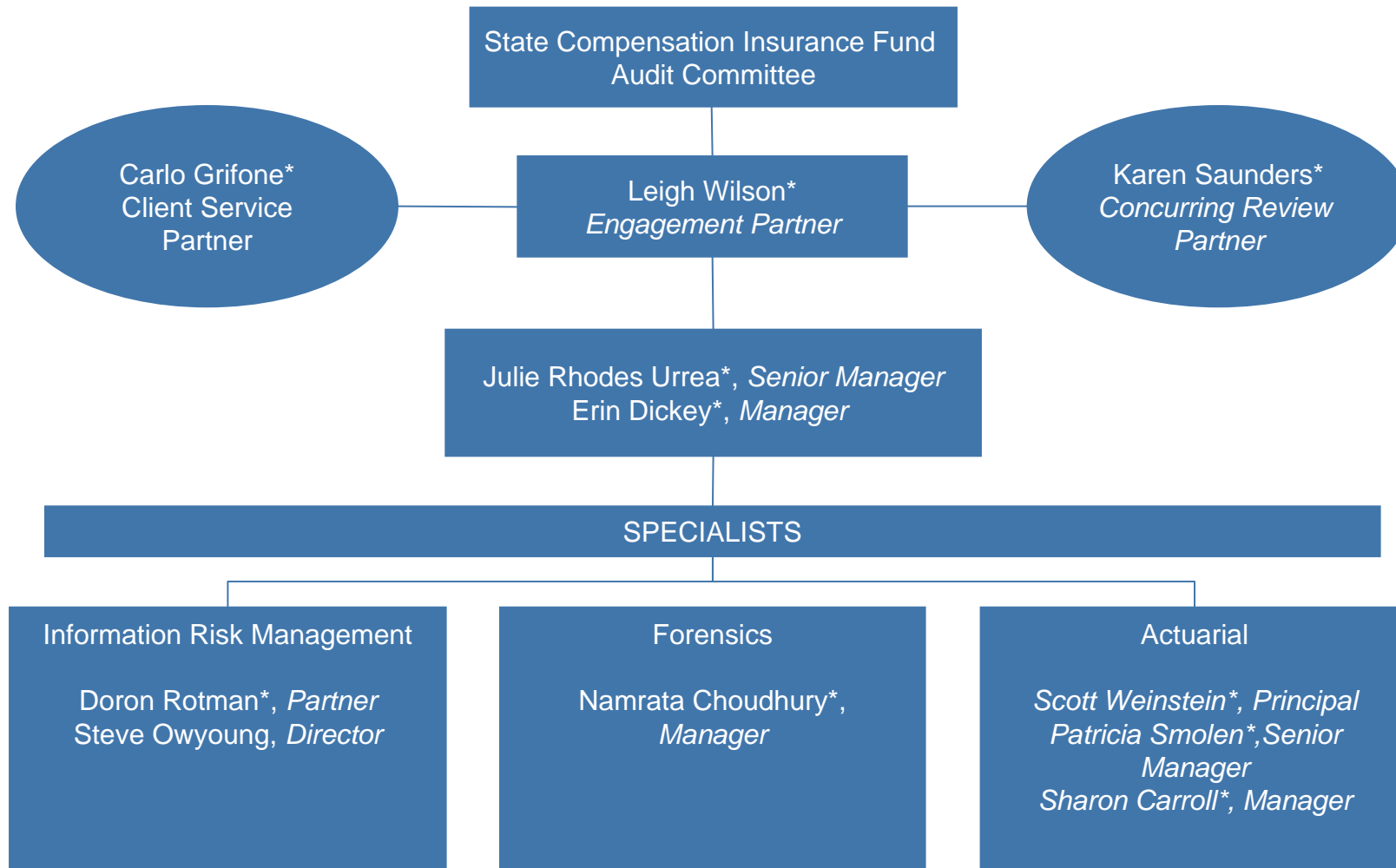
Open Session Materials

- 1.0 Client service team**
- 2.0 Objective of an audit**
- 3.0 Responsibilities**
- 4.0 KPMG's audit approach and methodology**
- 5.0 Risk assessment**
- 6.0 Audit plan**
 - Materiality
 - Deliverables and time line
 - Fraud risks
 - Material weakness and significant deficiency
- 7.0 Significant Audit Areas/Estimates**
- 8.0 KPMG's Ethics and Compliance Hotline**

1.0 Client service team

Client Service Team - Leadership

Open Session Materials



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

Role of KPMG Specialists - Significant Audit Areas/Estimates

Open Session Materials

<u>KPMG Specialist</u>	<u>Significant Account/Issue</u>	<u>Description of Involvement</u>
Loss Reserve Actuarial	Loss and loss adjustment expense, reinsurance risk transfer, earned but unbilled (EBUB), self-insurance	Review calculations, assumptions and analysis, discussions with Milliman and Company personnel, independent recalculations, review of new reinsurance agreements.
Scott Weinstein		
Patricia Smolen		
Sharon Carroll		
IT Advisory (ITA)	All significant accounts, due to pervasive nature of Information Technology risks	Test IT general and application controls and reports, assist with certain IT-dependent substantive test work.
Doron Rotman		
Steve Owyong		
Forensics	Statement of Accounting Standards No. 99, Consideration of Fraud in a Financial Statement Audit (SAS 99)	Assist with SAS 99 procedures, including assistance with identification of fraud risk factors and testwork over manual journal entries
Namrata Choudhury		
Securities Pricing Specialists	Investments	Provide independent pricing to test the fair value of marketable securities.
KPMG National Pricing Service		

2.0

Objective of an audit

Objective of an audit

Open Session Materials

- 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 provide reasonable, not absolute, assurance that the financial statements taken as a whole are free from material misstatement, whether from error or fraud.
- We design tests of controls to obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of the financial statements.

3.0 Responsibilities

Management is responsible for:

- Adopting sound accounting policies
- Fairly presenting the financial statements in conformity with statutory accounting principles (or in conformity with the instructions of the California State Controller's Office).
- Establishing and maintaining effective internal control over financial reporting (ICOFR)
- 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 the auditor with a letter confirming certain representations made during the audit that includes, but are not limited to management's:
 - disclosure of all significant deficiencies, including material weaknesses, in the design or operation of internal controls that could adversely affect the Company's ability to record, process, summarize, and report financial data; and
 - acknowledgement of their responsibility for the design and implementation of programs and controls to prevent and detect fraud
- MAR Responsibilities
 - Designate an Audit Committee
 - Accept responsibility for establishing and maintaining adequate internal control over financial reporting (ICOFR)
 - Identify framework used to evaluate ICOFR
 - Present written assessment regarding effectiveness of ICOFR, including disclosure of any material weaknesses identified by management

Management and Audit Committee Responsibilities Related to Fraud Risks

Open Session Materials

	Management	Audit Committee
Adopt sound accounting policies/oversight of the financial reporting process and ICOFR	√	
Establish and maintain appropriate controls to prevent, deter and detect fraud	√	√
Set the proper tone and create and maintain 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.

Responsibilities (continued)

Open Session Materials

KPMG is responsible for:

- Forming and expressing 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).
- Planning and performing the audit to obtain reasonable – not absolute – assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. Because of the nature of audit evidence and the characteristics of fraud, we are able to obtain reasonable, but not absolute, assurance that material misstatements will be detected.
- Evaluating:
 - (a) whether the Company's controls sufficiently address identified risks of material misstatement due to fraud; and
 - (b) controls intended to address the risk of management override of other controls
- Communicating to you 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
- Conducting our audit in accordance with professional standards
- Complying with the rules and regulations of 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
- Planning and performing our audit with an attitude of professional skepticism
- Communicating all required information, including significant matters, to management and the Audit Committee

4.0 KPMG's audit approach and methodology

KPMG's audit approach and methodology

Open Session Materials

1. Experienced team

We have an experienced team.

Our team includes the following specialists: Actuarial, Information Risk Management (IRM) and Forensics.

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 2012, we have based our approach on our understanding of State Fund's objectives and strategies and the challenges facing the business in 2012.

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 2012.

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.

KPMG's audit approach and methodology (continued)

Open Session Materials

Technology enabled audit work flow

Engagement Setup

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

Completion

- Verify accuracy, completeness, and appropriate presentation and disclosure of financial statements
- Form and issue audit opinion on financial statements
- Debrief audit process
- SAS 114 Required Audit Committee Communications



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

5.0 Risk Assessment

Risk Assessment – Other Areas of Audit Focus for 2012

Open Session Materials

Based on our understanding of the business, industry, and environment (including internal controls), the following are additional focus areas identified, ***other than the Company's significant audit areas/estimates*** (see section 7.0 below), that we will consider in the current year:

- Any changes to the Company's policy pricing/underwriting tools and procedure
- Pension and OPEB initiatives and any accounting impact
- Policyholder dividend payments
- Updated investment strategies such as investing in equity securities
- Legal and regulatory matters, including new legislation such as Senate Bill 863, and expected impact on loss experience
- Changes to premium billing terms and impact on the financial statements
- Catastrophe bond coverage
- General information technology environment including access and change management controls
- Key IT initiatives underway and planned, particularly those with impacts to financial reporting (billing/policy administrative system, claims, etc.)

6.0 Audit plan

Audit plan – Materiality

Open Session Materials

- 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.

Audit Plan – Deliverables and Timeline

Open Session Materials

<u>Deliverable</u>	<u>Date</u>
Statutory Audit Report	
Opinion on 2012 Statutory Financial Statements	May 2013
Opinion on 2012 Statutory Financial Statements including Schedules of Additional Information Formatted for the California State Controller's Office	September 2013
Other Reports	
Report on Schedules of Loss Experience, Premiums and Expenses for WCIRB (Review Opinion)	May 2013
Schedules and Letters	
Awareness letter	November 2012
Qualifications letter	May 2013
Internal controls letter	May 2013

Audit plan – Fraud risks

Open Session Materials

Identification 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

Response to identified fraud risks:

- Evaluate design and implementation of antifraud controls
- Test effectiveness of antifraud controls
- Address revenue recognition and risk of management override of controls
- Perform specific substantive audit procedures (incorporate elements of unpredictability)
- Evaluate audit evidence
- Communicate to management and the Audit Committee

Audit plan – Fraud risks (continued)

Open Session Materials

Fraud risks identified in planning	Impact on financial statements	Planned audit approach
<ul style="list-style-type: none"> ■ Loss and loss adjustment expense reserves, due to materiality and subjectivity of estimates ■ Risk of management override of controls <ul style="list-style-type: none"> – Journal entries and adjustments – Significant accounting estimates – Significant unusual transactions 	<p>Appropriateness of financial statement captions with the statement of admitted assets, liabilities, and policyholders' surplus, statement of operations and changes in policyholders' surplus, and statement of cash flows</p>	<ul style="list-style-type: none"> ■ Inquire of management and key process and control owners as to management override ■ Journal entry test work ■ Reconcile premium cash receipts and claims paid to banking records

Audit plan – Material weakness and significant deficiency

Open Session Materials

Material weakness

A deficiency, or combination of deficiencies, in ICOFR, such that there is a reasonable possibility that a material misstatement of the Company's annual financial statements will not be prevented or detected on a timely basis

Significant deficiency

A deficiency, or combination of deficiencies, in ICOFR that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the Company's financial reporting

Additional considerations

- Evaluation of the severity of a deficiency, individually or in combination, considers both qualitative and quantitative factors.
- The severity of a deficiency does not depend on whether a misstatement has actually occurred, but rather on whether there is a reasonable possibility that the Company's controls will fail to prevent or detect a material misstatement on a timely basis.
- More attention is given to the evaluation of deficiencies with the most potential to be material or important enough to merit the attention by those with oversight responsibility for the Company's financial reporting.

7.0 Significant Accounts/Estimates

Significant Audit Areas/Estimates

Open Session Materials

Significant Audit Area/Estimate	Selected Audit Procedures
Estimated Liabilities for Loss and Loss Adjustment Expense	<ul style="list-style-type: none">● Obtain an understanding of significant changes in pricing, underwriting, claims settlement practices, legal and legislative environment (Medicare set asides, etc.) 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● Engage KPMG Actuary to perform independent analysis of loss reserves and review Milliman'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

Significant Audit Areas/Estimates (continued)

Open Session Materials

Significant Audit Area/Estimate	Selected Audit Procedures
<p>Premiums Earned (including estimated Earned but Unbilled Premiums)</p>	<ul style="list-style-type: none"> ● Understand the impact of changes to the billing policies and system and impact on the financial statements (EBUB estimates, UEP calculations, etc.) and the audit ● 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

Significant Audit Areas/Estimates (continued)

Open Session Materials

Significant Audit Area/Estimate	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 ● Analytically review investment income and accrued 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

Significant Audit Areas/Estimates (continued)

Open Session Materials

Significant Audit Area/Estimate	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

8.0 KPMG's Ethics and Compliance Hotline

KPMG Ethics and Compliance Hotline
www.kpmgethics.com and 1-877-576-4033

Open Session Materials

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.



© 2012 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
26086NSS

The KPMG name, logo and “cutting through complexity” are registered trademarks or trademarks of KPMG International.