

State Compensation Insurance Fund

Audit Committee – Open Agenda Item 6: Report
of External Auditor

2016 Audit Plan and Status

November 16, 2016





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The Audit Committee of the Board of Directors
State Compensation Insurance Fund

November 4, 2016

Dear Members of the Audit Committee,

We look forward to discussing the current year audit plan and status of the State Compensation Insurance Fund (the Company) audit on November 16, 2016. At that meeting, we will outline the scope of our services, present the key considerations that will affect the 2016 audit, and provide the current status of certain key areas in greater detail. We are providing the enclosed materials so you can familiarize yourselves with them prior to our meeting.

The audit is designed to express an opinion on the 2016 financial statements. We are currently completing the interim phase of our audit and have aligned our procedures to consider the Company's current and emerging business risks and evaluate those that could materially affect the financial statements. We continue to receive the full support and assistance of the Company's personnel in conducting our audit.

At EY, we are committed to delivering the highest quality audit services, and we continually evaluate the quality of our professionals' work in order to meet or exceed your expectations. We encourage you to participate in our Assessment of Service Quality (ASQ) process to provide your input on our performance. The ASQ process is a critical tool that enables us to monitor and improve the quality of our audit services to State Compensation Insurance Fund.

This report is intended solely for the information and use of the Audit Committee, Board of Directors and management, and is not intended to be and should not be used by anyone other than these specified parties.

We appreciate that the Company selected EY to perform its 2016 audit and are committed to executing a quality audit that embraces the responsibility of serving the Audit Committee and public interest.

Very truly yours,

Carlos Gutierrez Jr

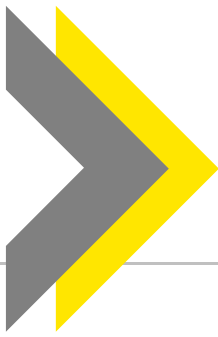
Monica M
Engage

Copy to: Vernon Steiner, CEO
Pete Guastamachio, CFO

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Executive summary

Audit timeline

- We will perform our interim procedures during the months of August through December 2016 and our year end procedures during the months of April through May 2017.

Audit scope and strategy

- Our audit scope and strategy, including significant risks identified, for the 2016 audit is outlined in the “Areas of audit emphasis” section on page 6.

Audit status

- Refer to page 8.

Topics to be discussed at the meeting with the Audit Committee:

Significant 2016 considerations:

- California workers’ compensation premium levels
- Loss reserve adequacy
- Technology changes
- Regulatory developments
- Cybersecurity

Areas of audit emphasis

Audit plan

Audit status:

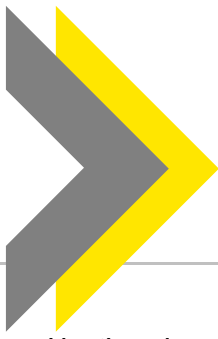
- Planning, risk assessments and walkthroughs

Audit and audit-related services

- Express an opinion on, and report to the Audit Committee, the results of our audit of the statutory-basis financial statements and other supplementary information of State Compensation Insurance Fund (the Company) in accordance with California statutory accounting principles
- Issue a written communication describing significant deficiencies and material weaknesses identified during our audit, if any
- Issue a report on internal control for filing with the state of California
- Issue a letter of qualification for filing with the state of California
- Issue a state awareness letter for filing with the state of California
- Issue a management letter including recommendations for improvements in controls and procedures, if applicable

Other services

- Provide Board Matters Quarterly and industry thought leadership to the Audit Committee and management



Our audit plan

Significant 2016 industry considerations

Industry considerations play a significant role in a company's financial condition, results of operations, cash flows and ability to continue as a going concern. We have designed our audit strategy to be responsive to such considerations. Industry considerations, include but are not limited to:

California workers' compensation premium levels

- California workers' compensation insurance rates declined during the second half of 2015. The overall slower growth in written premiums continues into 2016. This is largely attributable to lower medical inflation in the past three years since the passing of Senate Bill 863.
- California continues to have the highest workers' compensation insurance rates in the United States which are primarily driven by the higher frequency of litigated and permanent disability claims coupled with higher average claim costs (severity).
- Overall, in the direct market, soft rates continue to be driven by: excess capital, favorable reinsurance pricing and increased competition. New customer acquisition is increasingly more difficult in a declining rate environment.

Loss reserve adequacy

- Premium rate changes (primarily decreases) have recently been the result of new market entrants driving up supply and forcing prices downward. Although loss trends are improving relative to their 2010-2012 peak, the downward pressures on premium rates are not closely correlating to the high cost of California claims.
- In California, these increasing workers' compensation claim costs are partly driven by the higher frequency of permanent disability and litigated claims compared to the rest of the country.
- Recent increases in indemnity claim frequency specific to California are largely driven by increased claims in the Los Angeles area. The occurrence of cumulative trauma injuries in the Los Angeles area has more than doubled since 2008.

Technology changes

- In 2016, digital technologies, such as social media, analytics and telematics, will continue to transform the market landscape, recalibrating customer expectations and opening new ways to reach and acquire clients.
- The rise of the "Sharing economy," under which assets, such as cars and homes, can be shared, is requiring insurers to rethink traditional insurance models.
- Competitive pressures in the insurance industry have been building as cost-effective solutions in digital communication, distribution and infrastructure become widely available. Digital technology is eroding the advantages of scale enjoyed by established insurers and empowering smaller players to compete for market share through more flexible pricing models and new distribution channels.

Regulatory developments

- The National Association of Insurance Commissioners (NAIC) and the California Department of Insurance may separately advance their expectation of best practices in risk management, governance and solvency as current programs enter their second year of full rollout. All jurisdictions will likely push for better information, reporting and compliance in areas such as accounting, solvency, fair practices, transparency, governance practices and marketplace equity.
- Increasing frequency of cyber attacks at several well-known companies and institutions worldwide is making information security top-of-mind for businesses and consumers.
- Increased use of cloud computing by companies across all industries increases threats to data security, privacy and business continuity.
- A variety of federal organizations have increased their focus to better understand the cybersecurity risks that companies face and how they can be addressed.
- The NAIC adopted the *NAIC Roadmap for Cybersecurity Consumer Protections* (i.e., *Cybersecurity Bill of Rights*) which summarizes the general rights of insurance consumers relating to cybersecurity and breach of security notifications, along with best practices on protecting consumer information when a data breach occurs. The NAIC also drafted the *Insurance Data Security Model Law* which is expected to be approved in 2016.



Our audit plan

Areas of audit emphasis

Our audit procedures emphasize testing those accounts, contracts, processes or transactions where we believe there is the greatest risk of material misstatement to the financial statements, whether due to error or fraud.

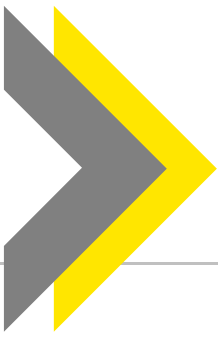
We consider the effects of current market risk factors and also place emphasis on those areas requiring subjective determinations by management. We also continue to evaluate risk factors specific to the California workers' compensation industry, such as negative premium trends and increases in claim frequency. We will update our risk assessments and reassess other internal and external factors influencing the Company throughout our audit, and communicate to you any changes to our initial plan, as necessary.

Our areas of audit emphasis, including areas with identified significant risks, are as follows:

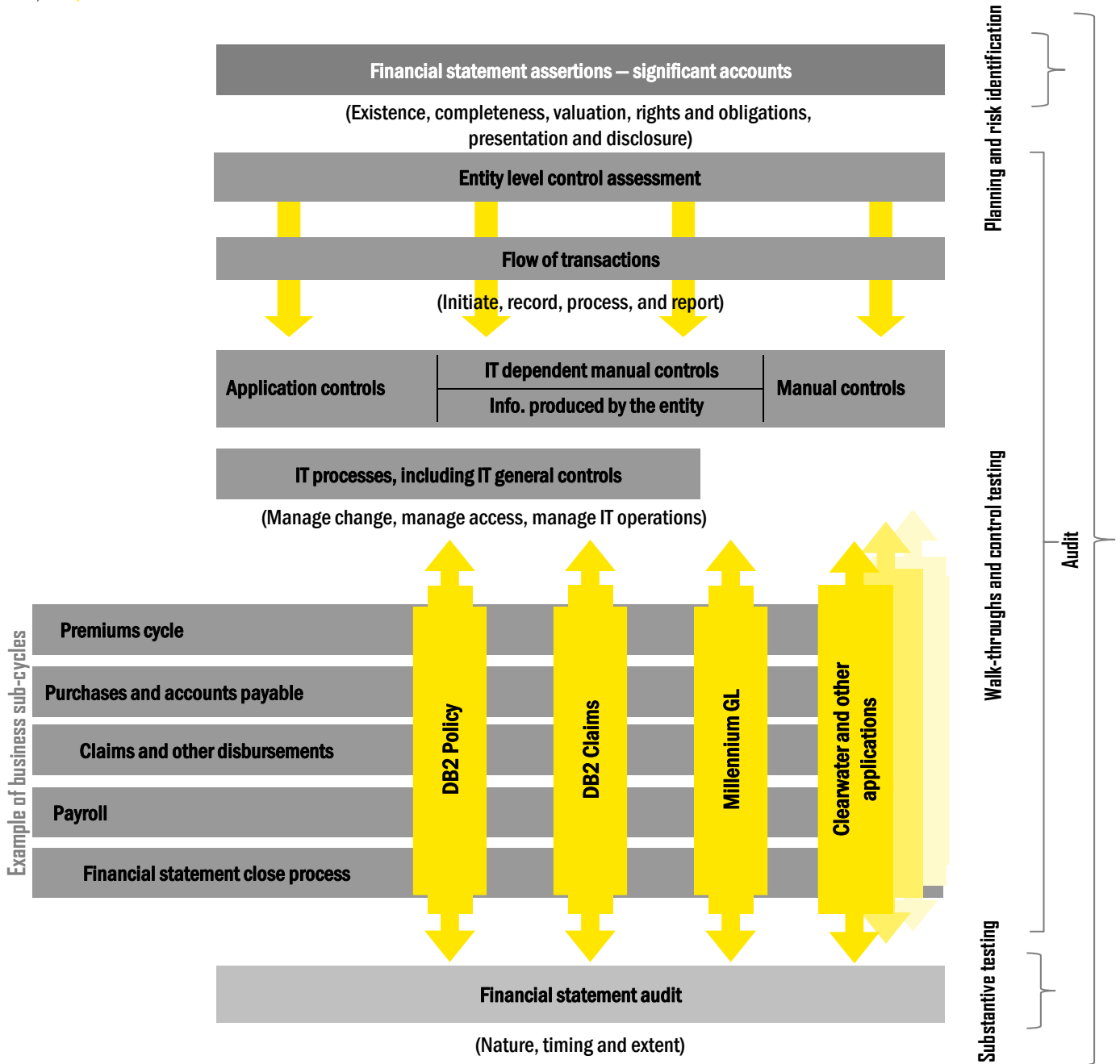
Area of audit emphasis	Obtain and Document Understanding	Specialist Involvement
• Loss and loss adjustment expenses (LAE) reserves	In progress	EY Insurance and Actuarial Advisory Services (IAAS)
• Pension and other post-retirement benefits (OPEB)	In progress	EY People Advisory Services (PAS)
• Investments (including Federal Home Loan Bank borrowing rate)	In progress	EY Structured Finance Advisory Services (SFAS)
• Reinsurance (including Loss Portfolio Transfer)	In progress	EY IAAS
• Premiums and earned but unbilled (EBUB) premiums	In progress	EY IAAS
• TAPP deposit liability **	Completed	None
• Self-insurance reserve **	Completed	EY IAAS

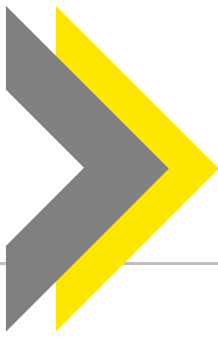
Accounts or transactions identified as having significant risks.

** *Based on our current understanding gained from meetings with Management, we determined these areas require greater audit focus.*



Our audit plan IT environment





Our audit status

Planning, risk assessments and walkthroughs

We agreed to provide the Audit Committee with periodic updates on the status of our audits, as well as our finding and observations. We have substantially completed our planning procedures and are in the process of finalizing our walkthroughs over significant processes.

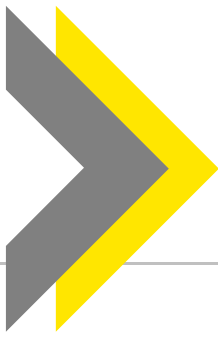
We have not made any significant changes to our audit plan. Our audit will focus on gaining a solid understanding of the processes below and employing an efficient mix of control and process reliance and substantive audit procedures.

Process	Understanding ¹	Risk and Control Assessment ²	Walkthrough ³
• Entity-level controls	Completed	Completed	Completed
• Financial statement close	Completed	Completed	Completed
• Payroll	In progress	In progress	In progress
• Claims	In progress	In progress	In progress
• Loss reserves	In progress	In progress	In progress
• Pension and OPEB	In progress	In progress	In progress
• Investments	In progress	Not started	Not started
• Premiums	Not started	Not started	Not started
• AP and cash disbursements	In progress	In progress	Not started
• Reinsurance	In progress	Not started	Not started

¹Obtained and examined the Company prepared narrative and discussed key steps with all process owners

²Assessed key risks and identified controls

³Obtained evidence of the process flow by selecting a transaction and tracing it through the process from initiation to reporting in the financial statements



Inquiries relating to matters relevant to the audit

We perform inquiries related to fraud and other matters to help inform our audit strategy and execution of our audit procedures. As a part of our upcoming meeting, we would like to discuss the following topics with you to understand any matters of which you believe we should be aware, including, but not limited to:

- Your views about the risks of material misstatements due to fraud, including the risks of management override of controls
- Your knowledge of any actual, alleged or suspected fraud
- How you exercise oversight on the Company's assessment of fraud risks and the establishment of controls to address these risks
- Your awareness of other matters, you believe, are relevant to the audit including, but not limited to, violations or possible violations of laws or regulations
- Your understanding of the Company's relationships and transactions with related parties that are significant to the Company

- Whether you have any concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns

When we identify a fraud risk, including a fraud risk that arises through or is associated with the risk of management override of controls, we perform audit procedures to address those risks. In addition to any specific responses related to the fraud risk, we also examine journal entries, review accounting estimates for management bias and evaluate the business rationale of significant unusual transactions as required by our professional standards.

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Our assurance services help our clients meet their reporting requirements by providing an objective and independent examination of the financial statements that are provided to investors and other stakeholders. Throughout the audit process, our teams provide timely and constructive challenge to management on accounting and reporting matters and a robust and clear perspective to audit committees charged with oversight.

The quality of our audit starts with our 60,000 assurance professionals, who have the breadth of experience and on-going professional development that comes from auditing many of the world's leading companies.

For every client, we assemble the right multidisciplinary team with the sector knowledge and subject-matter expertise to address your specific issues. All teams use our Global Audit Methodology and latest audit tools to deliver consistent audits worldwide.

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