Report of External Auditor

Audit Committee – Open Agenda Item 4

November 17, 2011

Leigh Wilson, KPMG

cutting through complexity™

State Compensation Insurance Fund Audit Plan December 31, 2011

November 17, 2011 (Open Session Materials)

Letter to Audit Committee

November 17, 2011

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, 2011.

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 2011 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

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1.0
Client Service Team

Client Service Team - Leadership

State Compensation Insurance Fund
Audit Committee

Carlo Grifone
Client Service Partner

Leigh Wilson*
Engagement Partner

Karen Saunders
*Concurring Review Partner**

Julie Rhodes Urrea*, *Senior Manager*

Erin Dickey*, *Manager*

SPECIALISTS

Information Risk Management

Gary Riske*, *Partner*

Helen Leung*, *Manager*

Forensics

Namrata Choudhury*, *Manager*

Actuarial

Leslie Marlo, *Managing Director*

Patricia Smolen*, *Senior Manager*

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

Significant Audit Areas/Estimates – Role of KPMG Specialists

KPMG Specialist	Significant Account/Issue	Description of Involvement
Loss Reserve Actuarial **Leslie Marlo** **Patricia Smolen**	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.
IT Advisory (ITA) **Gary Riske** **Helen Leung**	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.
Forensics **Namrata Choudhury**	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
Securities Pricing Specialists **KPMG National Pricing Service**	Investments	Provide independent pricing to test the fair value of marketable securities.

2.0
Objective of an Audit

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 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

Responsibilities

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

Responsibilities (continued)

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).
- 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

Responsibilities (continued)

Management is responsible for (continued):

- 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

	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.

4.0
KPMG and Audit Committee Involvement

KPMG's Involvement with the Audit Committee and Management

KPMG Involvement	
Audit Committee	• Attendance at Committee meetings, presentations of audit plan, independence, audit responsibilities, feedback on controls and required communications • Participation with management on qualitative assessment of accounting policies and estimates • Ongoing feedback in areas where Committee requests follow-up
Senior Management Team	• Meet regularly with all levels of senior management • Communicate continuously to keep abreast of developments and to provide adequate time to resolve issues and potential problems
Financial Reporting Team	• Provide technical review of accounting matters on a real-time basis • Discuss emerging accounting pronouncements and their impact on the organization • Continuous discussions of emerging accounting issues and their implication
Internal Audit	• Coordinate regularly with Internal Audit • Promote information-sharing and feedback on controls
Actuarial Management	• Discussion of the results of KPMG's analysis of reserves and underlying data • Discussion of emerging actuarial issues

5.0
KPMG’s Audit Approach and Methodology

KPMG's Audit Approach and Methodology (continued)

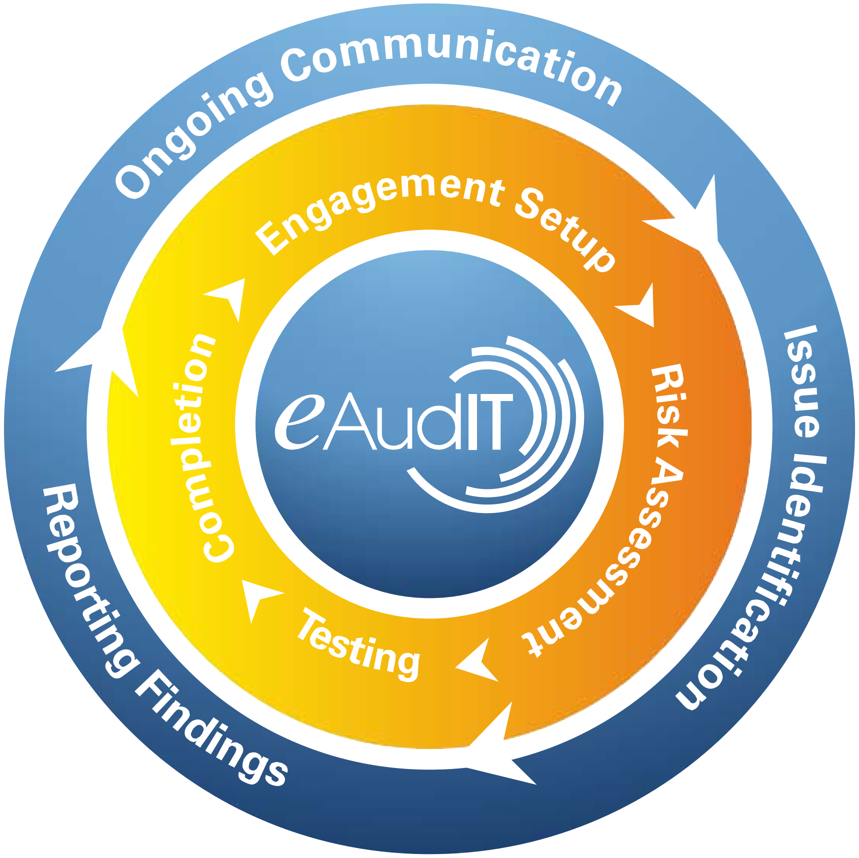
Technology Enables Audit Workflow

Engagement Setup

- Tailor the eAudIT workflow to your circumstances
- Access global knowledge specific to your industry

Risk Assessment

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



Completion

- Form and issue audit opinion on financial statements
- Issue management letter
- Debrief audit process

Testing

- Test effectiveness of your internal controls
- Perform substantive tests
- Verify accuracy, completeness and appropriate presentation and disclosure of financial statements

6.0
Audit Plan

Audit Plan – Deliverables and Timeline

Deliverable	Date
Statutory Audit Report	
Opinion on 2011 Statutory Financial Statements	May 2012
Opinion on 2011 Statutory Financial Statements including Schedules of Additional Information Formatted for the California State Controller's Office	September 2012
Other Reports	
Report on Schedules of Loss Experience, Premiums and Expenses for WCIRB (Review Opinion)	June 2012
Schedules and Letters	
Awareness letter	October 2011
Qualifications letter	May 2012
Internal controls letter	May 2012

Audit Plan – 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.
- The assessment of materiality is a matter of our professional judgment.
- 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 – Material Weakness and Significant Deficiency

Material Weakness

A deficiency, or combination of deficiencies, in internal control over financial reporting, 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 internal control over financial reporting 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.

Audit Plan – Material Weakness and Significant Deficiency (continued)

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
Risk Assessment

Risk Assessment – Areas of Audit Focus 2011

Evaluate Remediation of Prior Year Significant Deficiencies	Significant Estimates	Non-Routine Transactions	Information Technology Matters
• None	• Estimated Liabilities for Loss and Loss Adjustment Expense • Investments (including valuation of investments) • Reinsurance (including valuation of reinsurance recoverables) • Regulatory/Litigation matters and valuation of related reserves	• Assessing impact of soft market and decrease in renewals on loss ratios, recoverability, premium deficiency, etc. • Litigation and regulatory matters, including new legislation • Litigation related to reforms and pressure on loss reserves • Implementation of new accounting pronouncements when applicable	• General information technology environment • Any new systems implementations or existing systems upgrades including transition to cloud computing

Risk Assessment – Areas of Audit Focus 2011 (continued)

Based on our understanding of the entity's business, industry and environment (including internal controls), the following are additional risks identified (see Audit Areas of Focus for other areas) that we will focus on in the current year:

Risk	Financial Statement Impact	Planned Audit Approach
Company announced a reduction in force and consolidation of certain locations.	Appropriateness of Restructuring liabilities/expense	Obtain restructuring plan and determine whether the liability was recorded in the appropriate period in compliance with relevant accounting guidance
Loss and LAE adjustments	Assess any impact the claims center consolidation or reduction in force on actuarial data including timeliness of claims payments, case resave adequacy, and loss adjustment expected projected costs On-going analysis of California loss trends and projected impact on State Fund book of business	Discuss with CFO and obtain support for the adjustments to determine whether the adjustments were recorded in compliance with relevant accounting guidance. Obtain understanding of impact of claims consolidation on data such as claims closing rate, paid-to-incurred ratios and trends in average outstanding claim reserve. Review reported industry results and compare trends to State Fund actuarial metrics

Risk Assessment – Fraud Risks

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 anti-fraud controls
- Test effectiveness of anti-fraud 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

Risk Assessment – Fraud Risks (continued)

Fraud Risks Identified in Planning	Impact on Financial Statements	Selected Key Procedures
● Risk of misstatement relating to revenue recognition ● Risk of management override of controls – Journal entries and adjustments – Significant accounting estimates – Significant unusual transactions	● 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	● 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

8.0
Significant Audit Areas/Estimates

Significant Audit Areas/Estimates

Significant Audit Area/Estimate	Selected Audit Procedures
Estimated Liabilities for Loss and Loss Adjustment Expense	• Assess Company's methodology for evaluating adequacy of reserves and reasonableness and compliance with actuarial standards • KPMG Actuary performs independent analysis of the loss reserves and reviews Milliman's 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)

Significant Audit Area/Estimate	Selected Audit Procedures
Premiums Earned (including estimated Earned but Unbilled Premiums)	• 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 • Review the Company's calculation of premium deficiency • Assess appropriateness of financial statement disclosures

Significant Audit Areas/Estimates (continued)

Significant Audit Area/Estimate	Selected Audit Procedures
Investments (including valuation of investments)	• 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)	• 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 • Confirm terms of Loss Portfolio Transfer and related collateral • Recalculate the recorded recoverable of the Loss Portfolio Transfer • Assess appropriateness of financial statement disclosures

Significant Audit Areas/Estimates (continued)

Significant Audit Area/Estimate	Selected Audit Procedures
Regulatory/Litigation matters and valuation of related reserves	• 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

9.0
Appendix I

KPMG's Audit Committee Institute (ACI)
Communicating with Audit Committees Since 1999

Upcoming Events

- 8th Annual Audit Committee Issues Conference
  - East Coast – January 31, 2012 (Miami, FL)
  - West Coast – February 7, 2012 (San Francisco, CA)

    This conference brings together Audit Committee members from around the country to discuss challenges, practices, and priorities shaping Audit Committees and Board agendas.
  - Fall 2011 Audit Committee Roundtable Series: *Game-Changing IT and Other Developments Driving the Agenda* / November – December (25 locations)
- Audit Committee Quarterly Webcast Series – 2011
  - Dates TBA (11:00am-12:15pm EST)

  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.

Recent Publications

- Spring 2011 Audit Committee Roundtable Report
- Highlights from the 7th Annual Audit Committee Issues Conference
- ACI's Ten To-Do's for Audit Committees in 2011 – released December 2010

Resources

- *Audit Committee Insights – U.S. and International editions (biweekly electronic publications): www.kpmginsights.com*
- ACI Website: www.auditcommitteeinstitute.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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