

AUDIT COMMITTEE MEETING (OPEN)

AGENDA ITEM 3

ATTACHMENT 3-1

REPORT OF EXTERNAL AUDITOR

PRESENTED BY: Leigh Wilson, KPMG

NOVEMBER 18, 2010



INSURANCE

State Compensation Insurance Fund Audit Committee Meeting – Audit Plan

November 18, 2010 (Open Session Materials)

AUDIT



Letter to Audit Committee

Open Session Materials

November 18, 2010

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, 2010.

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 2010 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



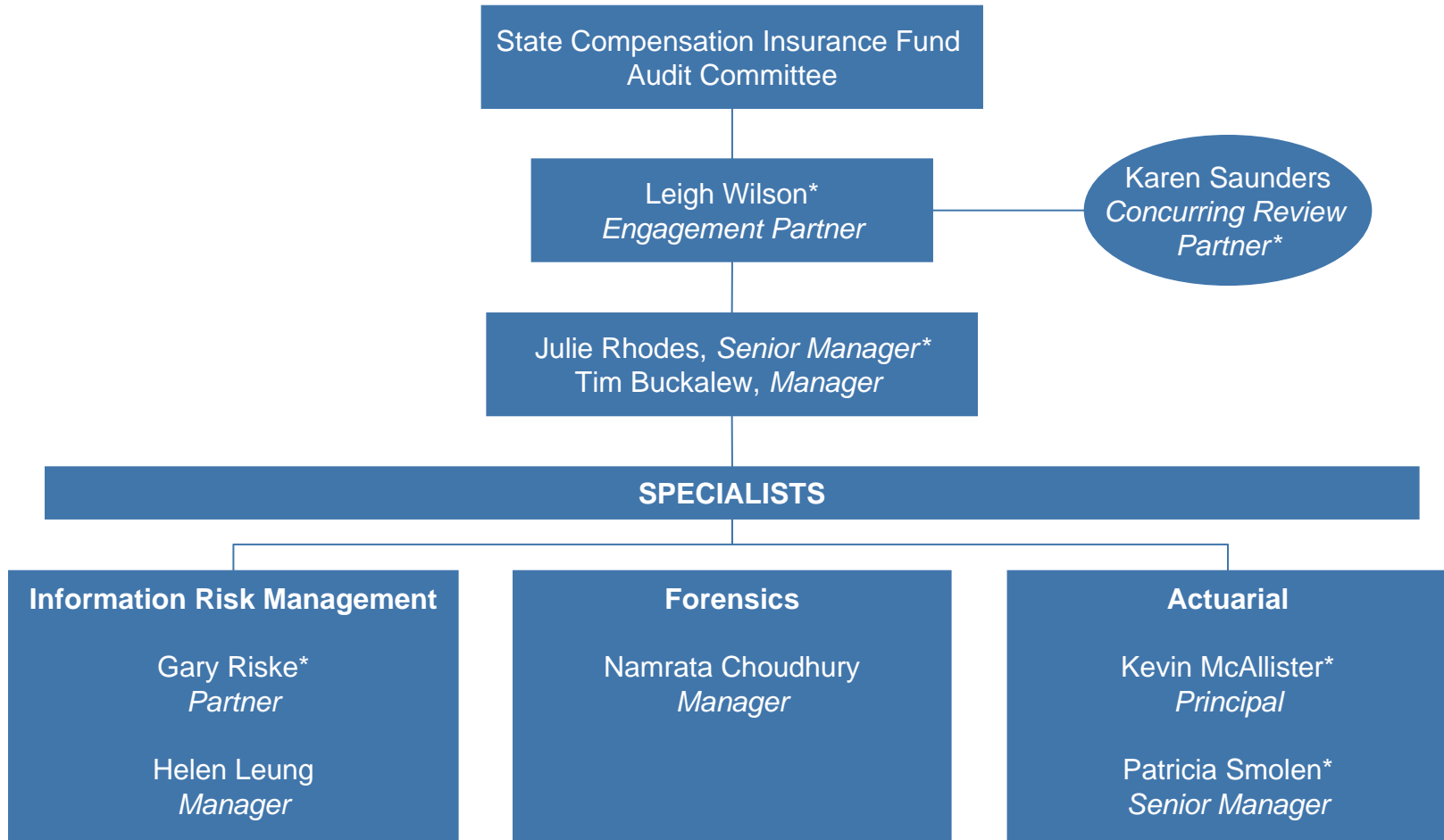
2010 Audit Plan

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 This report is not intended for general use, circulation or publication and should not be published, circulated, reproduced or used for any purpose without our prior written permission in each specific instance.

Client Service Team - Leadership

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





KPMG's Responsibility Under Professional Standards

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- 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 presented fairly, in all material respects, in conformity with statutory accounting principles (or U.S. GAAP, with respect to U.S. GAAP schedules).
- Conducting an audit in accordance with professional standards and complying with the Code of Professional Conduct adopted by the American Institute of Certified Public Accountants.
- Complying with the ethical standards of state CPA societies, state boards of accountancy, and the California Department of Insurance.
- Planning and performing an audit with an attitude of professional skepticism.
- Communicating all required information to management and to the Audit Committee.

KPMG's audit of the financial statements does not relieve management or the Audit Committee of their responsibilities.





Management's Responsibility

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- General Responsibilities
 - Adoption of sound accounting policies
 - Establishing and maintaining internal control
 - The fair presentation, in accordance with statutory accounting principles (and U.S. GAAP, with respect to U.S. GAAP schedules), of the financial statements and schedules and all representations and disclosures contained within
- MAR Responsibilities
 - Designate an Audit Committee
 - Accept responsibility for establishing and maintaining adequate 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

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	Management	Audit Committee
Adopt sound accounting policies	√	
Establish appropriate controls to prevent, deter and detect fraud	√	√
Set the proper tone and create and maintain a culture of honesty and high ethical standards	√	√

An overhead photograph showing two individuals, a man and a woman, seated at a table. They are looking at documents and appear to be in a professional meeting or discussion. The man is on the left, and the woman is on the right. There are papers, a pen, and a coffee cup on the table.

KPMG's Responsibilities Related to Fraud

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- Our responsibility is to conduct the audit in accordance with generally accepted auditing standards and plan and perform the audit to obtain reasonable 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 are detected.



Approach to Fraud Risks – Some of What KPMG considers

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Incentives / pressures

- Business pressures
- Internal pressures
- Third party pressures
- Communications to public
- Incentive compensation
- Financial interests

Opportunities (easiest to commit / hardest to detect)

- Identified financial statement or assertion level fraud risks
- Account balances or classes of transactions
- Particular operating locations or business segments
- Related party or significant unusual transactions
- Ineffective controls or oversight

Attitudes / rationalizations

- Integrity
- Attitudes toward selection and implementation of accounting policies and practices
- Attitudes toward internal control over financial reporting

Knowledge of suspected or alleged fraud

- Non-compliance with ethical standards
- Identified management misconduct or override of controls
- Disclosures related to applicable regulations
- Reported suspected or alleged fraud or misconduct



Some of the Ways KPMG Addresses Fraud Risks in the Audit

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- 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 audit team the susceptibility of the entity to fraud
 - Inquire of management, audit committee and others
 - Evaluate broad programs/controls that prevent, deter, and detect fraud
- Response to identified fraud risks
 - Evaluate design and implementation of mitigating controls
 - Test effectiveness of 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 audit committee



Materiality

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- Professional standards require that we exercise professional judgment when we consider audit risk and materiality both in planning the audit and designing 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.

KPMG Involvement with the Audit Committee and Management

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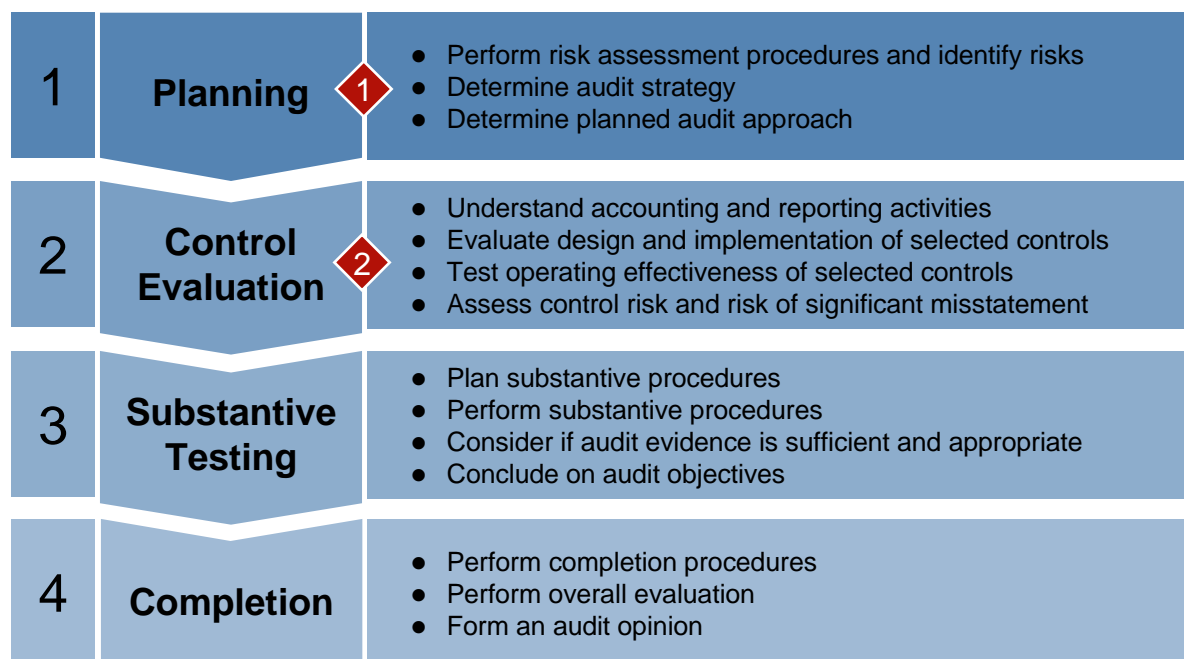
KPMG Involvement	
Audit Committee	<ul style="list-style-type: none"> ● Attendance at Committee meetings, presentations of audit plan, independence, audit responsibilities, feedback on controls and required communications ● Participation with management on qualitative assessment of accounting policies and estimates ● Ongoing feedback in areas where Committee requests follow-up
Senior Management Team	<ul style="list-style-type: none"> ● 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	<ul style="list-style-type: none"> ● 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	<ul style="list-style-type: none"> ● Coordinate all audit efforts at home office and district offices selected for site visits ● Coordinate regularly with Internal Audit ● Promote information-sharing and feedback on controls
Actuarial Management	<ul style="list-style-type: none"> ● Discussion of the results of KPMG's analysis of reserves and underlying data ● Discussion of emerging actuarial issues


Areas of 2010 Audit Focus


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Evaluate Remediation of Prior Year Significant Deficiencies	Areas Resulting in Audit Adjustments in Recent Years	Non-Routine Transactions	Information Technology Matters
<ul style="list-style-type: none"> • None 	<ul style="list-style-type: none"> • Estimated liability for self-insurance • Earned but unbilled premium • Accrued vacation liability • Premium tax refund 	<ul style="list-style-type: none"> • 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 • Related party transactions • Implementation of new accounting pronouncements when applicable 	<ul style="list-style-type: none"> • General information technology environment • Any new systems implementations or existing systems upgrades

Four-phase audit workflow



 **Preliminary** decision on controls or substantive approach for each audit objective

 **Confirm** decision on controls or substantive approach for each audit objective

Critical and Significant Audit Areas and Estimates – Selected Audit Procedures

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Critical Audit Areas/Estimates	Selected Audit Procedures
Estimated Liabilities for Loss and Loss Adjustment Expense	<ul style="list-style-type: none">● Assess Company’s methodology for evaluating adequacy of reserves and reasonableness and compliance with actuarial standards● KPMG Actuary performs independent analysis of the estimate● 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

Critical and Significant Audit Areas and Estimates – Selected Audit Procedures, continued

Open Session Materials

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

Critical and Significant Audit Areas and Estimates – Selected Audit Procedures, continued

Open Session Materials

Significant Audit Area/Estimate	Selected Audit Procedures
<p>Investments (including valuation of investments)</p> <p>Primarily fixed maturities</p>	<ul style="list-style-type: none"> ● 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
<p>Reinsurance (including valuation of reinsurance recoverables)</p>	<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 ● Confirm terms of Loss Portfolio Transfer and related collateral ● Recalculate the recorded recoverable of the Loss Portfolio Transfer ● Assess appropriateness of financial statement disclosures

Critical and Significant Audit Areas and Estimates – Selected Audit Procedures, 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

Role of KPMG Specialists

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KPMG Specialist	Significant Account/Issue	Description of Involvement
Loss Reserve Actuarial Kevin McAllister 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.



Key KPMG Deliverables – Timetable

Open Session Materials

	Date
Statutory Audit Report	
Opinion on 2010 Statutory Financial Statements	May 2011
Opinion on 2010 Statutory Financial Statements including Schedules of Additional Information Formatted for the State of California State Controllers Office	September 2011
Other Reports	
Report on Schedules of Loss Experience, Premiums and Expenses for WCIRB (Review Opinion)	June 2011
Report on Medical Payments under US Longshore and Harbor Workers' Compensation Act (Audit Opinion)	September 2011
Schedules and Letters	
Qualifications letter	May 2011
Internal controls letter	June 2011





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.

