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Date: November 7, 2014

**TO: MEMBERS, AUDIT COMMITTEE**

<b>I. AGENDA ITEM # AND TITLE :</b>	Open Agenda Item 6 – Report of External Auditor: KPMG 2014 Audit Plan
<b>II. NAME AND PROGRAM:</b>	KPMG – External Audit
<b>III. ACTIVITY:</b>	<input checked="" type="checkbox"/> Informational <input type="checkbox"/> Request for Direction <input type="checkbox"/> Action Proposed
<b>IV. JUSTIFICATION:</b>	<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 2014 Statutory Financial Statements. Key talking points – KPMG client service team and key auditing and accounting matters for State Fund in 2014.

**VI. ANALYSIS:**

Overall, KPMG’s team will be fairly consistent with prior year. Key areas of focus for the 2014 audit include: loss and loss adjustment expense reserving – including a hindsight review of prior year estimates and focus on the 2014 (lead year) estimate; tiered pricing and related increase in new business; and impact of Senate Bill 863.

**VII. RECOMMENDATION:**

We recommend the Audit Committee review KPMG’s 2014 Audit Plan.

**VIII. PRESENTATION EXHIBITS:**

Includes the 2014 Audit Plan

**IX. APPENDIX I and II:**

Substantive Testing Approach and Selected Other Information



*cutting through complexity*

**State Compensation Insurance Fund  
Audit Committee – November 19, 2014  
Open Agenda Item 6 – Report of External Auditor**

**Audit Plan  
December 31, 2014**

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November 19, 2014 (OPEN SESSION MATERIALS)

# Agenda

## Client service team

## Scope and key deliverables

## Summary of key auditing and accounting matters for 2014

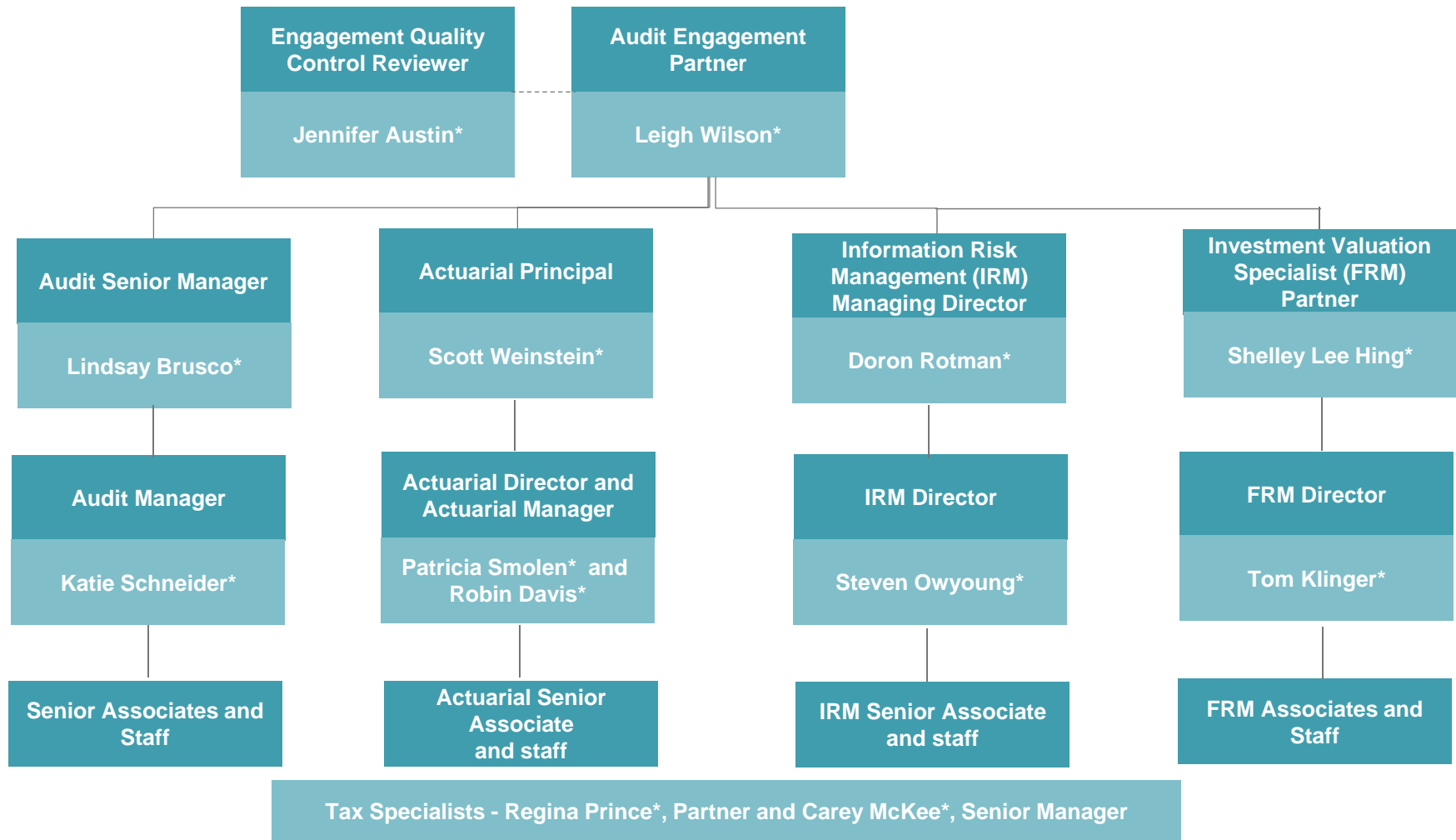
### Appendix I

- **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**
- **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*

## Scope and Key Deliverables

Report/Deliverables	Timing
<ul style="list-style-type: none"> <li>■ Opinion on 2014 Statutory Financial Statements of the Company prepared by management with the oversight of the Audit Committee presented in conformity with the statutory accounting practices prescribed or permitted by the California Department of Insurance</li> </ul>	<p>May 2015</p>
<ul style="list-style-type: none"> <li>■ Material written communications between KPMG and management</li> <li>■ Required audit committee communications</li> <li>■ Awareness Letter</li> <li>■ Qualification Letter</li> <li>■ Internal Control Letter</li> </ul>	<p>Ongoing</p> <p>Ongoing</p> <p>Nov 2014</p> <p>May 2015</p> <p>May 2015</p>

# Summary of key auditing and accounting matters for 2014

Key audit areas/estimates/considerations		Significant unusual transactions/other items	Information technology matters
<ul style="list-style-type: none"> <li>■ Valuation of loss and loss adjustment expense reserves</li> <li>■ Valuation of State Fund's portion of the pension and other postemployment benefit obligation</li> <li>■ Valuation of investments</li> <li>■ Valuation of reinsurance recoverables</li> <li>■ Existence of premiums</li> </ul>	<p><b>2014 Specific Key Considerations:</b></p> <ul style="list-style-type: none"> <li>■ Hindsight review of PY estimates; analysis of impact on KPMG range and selected relative to Company carried</li> <li>■ 2014 (lead year) estimate</li> <li>■ Tiered Pricing and related increase in new business (review of KPI's such as tier distribution, PCPEU and "to-date" incurred and reported loss rates by tier compared with rate filings; closing rates; impact of increasing workloads - U/W , claims; controls around U/W (IT and manual)</li> <li>■ Impact of Senate Bill 863</li> </ul>	<ul style="list-style-type: none"> <li>■ KPMG plans to review significant, non-routine transactions occurring in 2014, such as:                             <ul style="list-style-type: none"> <li>- Related party transactions, if any</li> <li>- Litigation and regulatory matters</li> <li>- Implementation of new accounting pronouncements and auditing standards, as applicable</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>■ General information technology environment, including any developments related to 2013 IT significant deficiency , primarily related to access</li> <li>■ Consideration of impact of continued systems implementations and enhancements on audit risk (i.e., changes to IT controls; capitalized costs, etc.)</li> </ul>

# Appendix I:

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## Substantive testing approach – Key risks

Audit Area	Selected Audit Procedures
<b>Estimated Liabilities for Loss and Loss Adjustment Expense</b>	<ul style="list-style-type: none"> <li>● Engage KPMG Actuary to perform independent analysis of loss reserves and review the Company's loss and loss adjustment expense reserve analysis</li> <li>● Obtain an understanding of significant changes in pricing, underwriting, claims settlement practices, workload and backlog factors, legal and legislative environment and similar factors, and assess impact on loss and LAE reserve estimates</li> <li>● Assess Company's methodology for evaluating adequacy of reserves and reasonableness and compliance with actuarial standards</li> <li>● Understand Company's evaluation of differences among estimates (internal actuaries vs. consulting actuaries, etc.) , and understand the basis for any material differences between recorded reserves and internal actuarial analysis.</li> <li>● Assess completeness and accuracy of the underlying data used by the Company's actuaries in determining IBNR by agreeing significant data to underlying records (i.e. review a sample of claim file data within the system to actuarial triangles utilized for IBNR determination)</li> <li>● Reconcile claims paid as recorded in the ledger to banking records</li> <li>● Assess appropriateness of financial statement disclosures</li> </ul>



## Substantive testing approach – Key risks (continued)

Audit Area	Selected Audit Procedures
<b>Investments</b>	<ul style="list-style-type: none"> <li>● Confirm existence of investments with custodian and reconcile to underlying ledgers.</li> <li>● Understand Company's approach to pricing investment securities</li> <li>● Perform independent price testing and impairment analysis with particular focus on credit markets disruption and impact on investment portfolio</li> <li>● Perform test of details over investment income</li> <li>● Assess appropriateness of relevant financial statement disclosures</li> </ul>
<b>Reinsurance</b>	<ul style="list-style-type: none"> <li>● Read significant current year contracts and evaluate for compliance with applicable accounting pronouncements (e.g. risk transfer vs. deposit accounting); evaluate any material changes in existing contracts</li> <li>● Assess the Company's methodology for assessing the collectability of recoverables, including obtaining an update on prior year reinsurance dispute</li> <li>● Recalculate ceded balances and reinsurance recoverable</li> <li>● Assess the Company's accounting for the Catastrophe bond coverage</li> <li>● Confirm terms of significant reinsurance contracts and related collateral</li> <li>● Recalculate the recorded recoverable of the Loss Portfolio Transfer</li> <li>● Assess appropriateness of financial statement disclosures</li> </ul>

## Substantive testing approach – Key risks (continued)

Audit Area	Selected Audit Procedures
<b>Premiums</b>	<ul style="list-style-type: none"> <li>● Reconcile premiums received as recorded in the ledger to banking records</li> <li>● Assess completeness and accuracy of the underlying data used in the calculation of unearned premium (UEPR) (i.e. review a sample of policy file data within the system for the relevant attributes utilized in the calculation of UEPR)</li> <li>● Assess appropriateness of the allowance for premium receivable</li> <li>● Test completeness and accuracy of the timely and accurate premium payments (TAPP) deposit liability</li> <li>● Evaluate the Earned but Unbilled (EBUB) accrual, including consideration of impact of 2014 increases in audit premium</li> <li>● Assess appropriateness of financial statement disclosures</li> </ul>

## Substantive testing approach – Key risks (continued)

Audit Area	Selected Audit Procedures
<b>Estimate of State Fund’s portion of the pension and other postemployment benefit obligation</b>	<ul style="list-style-type: none"> <li>● Obtain an understanding of significant changes in the Company’s determination of the estimate of the unfunded liability</li> <li>● Assess Company’s methodology and any third party documentation for evaluating adequacy of the unfunded liability</li> <li>● Obtain an understanding of the Company’s process to come up with a range to estimate the total contingency</li> <li>● Assess appropriateness of financial statement disclosures</li> </ul>
<b>Regulatory/Litigation matters and valuation of related reserves</b>	<ul style="list-style-type: none"> <li>● Confirm the status and expected outcome of significant litigation with external counsel</li> <li>● Assess any identified cases for potential accrual or disclosure</li> <li>● Assess emerging and ongoing regulatory and legislative issues with general counsel and assess for any potential accounting impact</li> <li>● Assess appropriateness of financial statement disclosures</li> </ul>

## Substantive testing approach – Key risks (continued)

Audit Area	Selected Audit Procedures
<b>General IT Controls (“GITC”)</b>	<ul style="list-style-type: none"> <li>● Key areas of GITC testing include system access, program changes, program development, computer operations</li> <li>● Test the access control design and effectiveness for all financially significant applications and the related underlying databases and operating platforms</li> <li>● Test segregation of duties and emergency change control is in place</li> <li>● Test the design and effectiveness of change management program controls for all financially significant applications</li> <li>● Assess the Company’s assessment of the back-up and disaster recoverability of financial data and test the Company’s job monitoring process               <ul style="list-style-type: none"> <li>○ Testing for program development is aimed at projects that have financial significance to the Company and its infrastructure</li> </ul> </li> <li>● Monitor on-going IT transformation and any impact to current year audit</li> <li>● Assess remediation efforts regarding prior year deficiencies</li> </ul>

# 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

- Loss and loss adjustment expense reserves, due to materiality and subjectivity of estimates (management judgment)
- Risk of management override of controls
  - Top-side journal entries
  - Misappropriation of assets leading to financial statement misstatement

## Our audit procedures related to fraud risks include:

- |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
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| <ul style="list-style-type: none"> <li>■ Conduct interviews in accordance with AICPA AU-C 240, <i>Consideration of Fraud in a Financial Statement Audit</i></li> <li>■ Evaluate of risk of management override of controls - Inquire of management and key process and control owners as to management override.</li> <li>■ Evaluate design and implementation and test the operating effectiveness of certain anti-fraud controls, including bank reconciliation and segregation of duties controls</li> <li>■ Perform testwork over select "high-risk" journal entries and adjustments</li> <li>■ Perform specific substantive audit procedures (incorporate elements of unpredictability)</li> <li>■ Confirm cash and investments with third parties</li> </ul> | <ul style="list-style-type: none"> <li>■ Review support for significant estimates and discuss rationale with management</li> <li>■ 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.</li> <li>■ Obtain KPMG actuarial review of loss reserves and evaluate significant differences from carried reserves.</li> <li>■ Reconcile premium cash receipts and claims cash paid to banking records</li> <li>■ Review significant, unusual transactions – as applicable</li> <li>■ Communicate with the Audit Committee</li> </ul> |
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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.
- 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 due to fraud or error. 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 presentation of the financial statements.

## Selected other information – Responsibilities

### Management is responsible for:

- Adopting sound accounting policies
- Fairly presenting the financial statements, including disclosures, in conformity with statutory accounting principles prescribed or permitted by the California Department of Insurance.
- Establishing and maintaining effective internal control over financial reporting (ICFR), including programs and controls to prevent, deter, and detect fraud
- Identifying and ensuring that the Company complies with laws and regulations applicable to its activities, and for informing the auditor of any known material violations of such laws and regulations
- Making all financial records and related information available to the auditor
- Providing unrestricted access to personnel within the entity from whom the auditor determines it necessary to obtain audit evidence
- Adjusting the financial statements to correct material misstatements
- Providing the auditor with a letter confirming certain representations made during the audit that includes, but is 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 financial reporting
  - Acknowledgement of their responsibility for the design and implementation of programs and controls to prevent, deter, and detect fraud
  - Affirmation 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



## Selected other information – Responsibilities (continued)

### 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

### The Audit Committee is responsible for:

- Oversight of the financial reporting process
- Oversight of the establishment and maintenance by management of programs and internal controls designed to prevent, deter, 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 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 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 management and the Audit Committee 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

## Technology enabled audit work flow

### Engagement Setup

- Tailor the eAudit work flow to your circumstances
- Access global knowledge specific to your industry
- Team selection and timetable

### Completion

- Perform overall evaluation of results and the financial statements
- Form and issue audit opinion on the financial statements
- Obtain written representations from management
- Required Audit Committee communications
- Debrief audit process



### Risk Assessment

- Understand your business and financial processes
- Identify significant risks
- Plan involvement of specialists and others including experts
- Determine audit approach
- Evaluate design and implementation of your internal controls

### Testing

- Test effectiveness of internal controls, as applicable
- 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 misstatement or omission could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
- Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.
- 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

### 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
- The 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.

## Selected other information - KPMG Independence Quality Controls

### **KPMG maintains a comprehensive system of quality controls designed to maintain our independence**

- Pre-approval of all worldwide engagements by the audit engagement team through Sentinel, a KPMG independence verification system
- Monitoring employment relationships
- Tracking partner rotation requirements using PRS, the firm's automated partner rotation tracking system
- Automated investment tracking system used by all KPMG member firms (KICS)
- Training and awareness programs
- Compliance testing programs
- Annual reporting to the Audit Committee

## Selected other information - Independence

Nonaudit 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.



## Selected other information - Independence – New requirements

### Change to KPMG policies resulting from changes in the IESBA Code – Effective April 1, 2014

- This change does not change any independence requirements, only the requirements for communicating independence breaches, should one occur
- For any breaches of the IESBA independence requirements, KPMG will:
  - Assess the impact of the breach
  - Identify the actions performed or to be performed to address the consequences of the breach
  - Communicate in writing and discuss the breach and actions to address the breach with the Audit Committee
    - Significant breaches are communicated to the Audit Committee “as soon as possible” – all other breaches of the Code shall be communicated on a timely basis
  - Obtain concurrence from the Audit Committee on our conclusion regarding the breach (i.e., that the actions taken satisfactorily address the consequences of the breach)
  - Document the details of the breach, the actions described above and the result
- Breaches of AICPA rules and any violations involving a member of the audit engagement team will be reported consistent with the requirements described above
- Less significant breaches of AICPA rules shall be reported on the basis agreed with the Audit Committee

## Selected other information - KPMG's Audit Committee Institute (ACI) *In depth insights. In time to matter.*

### ACI Programs

- Audit Committee Roundtable Series
  - approximately 30 cities each Spring/Fall
- Tapping International Markets: Key Governance Challenges
  - December 11, 2014 (Los Angeles and Silicon Valley)

### Suggested Publications (available for download at [www.kpmg.com/aci](http://www.kpmg.com/aci))

- Directors Quarterly
- Global Boardroom Insights
- 2014 Audit Committee Priorities
- 2014 Global Audit Committee Survey

### Resources

- ACI Web site: [www.kpmg.com/aci](http://www.kpmg.com/aci)
- ACI mailbox: [auditcommittee@kpmg.com](mailto:auditcommittee@kpmg.com)
- ACI hotline: [1-877-KPMG-ACI](tel:1-877-KPMG-ACI)

**Selected other information –  
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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