

**LIFE INSURANCE COMPANY  
OF ALABAMA**

INTERNAL AUDIT REPORT  
NOVEMBER 3, 2014



**WILLIS BOATNER PUGH**  
CERTIFIED PUBLIC ACCOUNTANTS



**Internal Audit Report  
Life Insurance Company of Alabama**

**TABLE OF CONTENTS**

<b>LIFE INSURANCE COMPANY OF ALABAMA</b>	<b><u>PAGE NUMBER</u></b>
Controls tested and definition of risk	3
Controls tested:	
Fixed assets	4
Accounts payable	5
Investments	7
Payroll	8
Agent file testing	10
Benford's Law testing	11
Summary of suggestions for improvement	14



**Internal Audit Report**  
**Life Insurance Company of Alabama**

Listed below are the internal audit recommendations that were examined in the months of January through June 2014. A summary of suggestions for improvement by control is included for your information. Management may wish to develop a letter of response to this report to detail how items are going to be implemented or that a change will not be placed into operation for a specific suggestion.

**Controls tested**

1. Fixed assets
2. Accounts payable
3. Investments
4. Payroll
5. Agent file testing
6. Benford's Law testing

<b>Observations by Risk</b>		
<b>High</b>	<b>Medium</b>	<b>Low</b>
		X
	X	
	X	
	X	
		X
X		

The report includes our findings, suggestions for improvement and assessed level of risk. Below is the criteria used for the assessment of risk.

**Assessment of Risk:**

**High (H)** – Significant impact to the Company. Individually or aggregately material in terms of financial impact, external compliance violation, adverse publicity, significant or pervasive weakness in control environment, significant inefficiencies, etc.

**Medium (M)** – Moderate in terms of impact to the Company. Individual instance or an aggregate of low risk items considered moderate terms of financial impact, compliance violation, adverse publicity, weakness in control environment, efficiency, etc.

**Low (L)** – Low in terms of impact to the Company. Relatively immaterial in terms of financial impact, no external compliance violation, little adverse publicity, minor inefficiencies, etc.



**Internal Audit Report  
Life Insurance Company of Alabama**

**Internal Audit Summary Report  
Fixed Assets**

Observations by Risk		
H	M	L
		X

**Background:**

This test was an assessment of the internal controls related to fixed asset. It was included in the internal audit plan due to the importance of having proper capitalization or expensing procedures.

**Scope and Approach:**

Our evaluation included the following procedures related to fixed assets of the Company:

- Developed an understanding of the processes and controls in place for fixed assets by obtaining the Company's capitalization policy.
- Evaluated the accuracy and completeness of expenses incurred during the first and second quarters of 2014 as they related to fixed assets or repairs and maintenance and verified they were in compliance with the Company's policy. Evaluate the assets added to the fixed asset detail as being properly capitalized and that asset lives were in compliance with the Company's capitalization policy.
- Verified that the subsidiary ledger of fixed assets agreed to the general ledger.

**Key Highlights:**

- For the first and second quarter of 2014 expenditures described above, no observations were noted.
- For the verification of the subsidiary ledger to the fixed asset schedule for the first and second quarter, no observations were noted.

**Suggestions for Improvement or Observations Noted:**

- During the first and second quarters of 2014 testing, we noted no additional suggestions for improvements or observations.
- Life Insurance of Alabama has modified their accounting policy for fixed assets to incorporate previous suggestions, which were approved on May 5, 2014.





**Internal Audit Report  
Life Insurance Company of Alabama**

**Internal Audit Summary Report  
Accounts Payable**

Observations by Risk		
H	M	L
	X	

**Background:**

Accounts payable is a critical portion of the Company's financial records and can be subject to fraud without careful reconciliation and oversight. This test was an assessment of the internal controls related to accounts payable. It was included in the internal audit plan due to the importance of having proper controls over expenses incurred by the Company and proper payment and review procedures.

**Scope and Approach:**

Our evaluation included the following procedures related to the accounts payable of the Company:

- Developed an understanding of the processes and controls in place for accounts payable by obtaining the Company's cash disbursement policy. Develop an understanding of each key control the Company has over cash disbursements.
- Obtain a detail of all disbursements from account 112200 for the first six months of the 2014 year and sorted the detail by check type. Randomly selected 30 checks from each type of disbursement: general accounts payable expenses, LSP and HCP expenses to test for proper key control compliance.
- From the sample selected, each significant control area for general accounts payable was tested for proper compliance with the policy. Controls tested were as follows:
  - Two staff members approved the invoice.
  - Checks were filed in the electronic system with all required documentation to support the expense.
  - Checks were properly posted to the general ledger and general ledger account selected appeared to be appropriate.
  - Check amount posted to the general ledger agreed to the electronic system scanned file.
- From the sample selected, each significant control area for LSP disbursements was tested for proper compliance with the policy. Controls tested were as follows:
  - Approval of payment was noted.
  - Checks were filed in the electronic system with all required documentation to support the expense.
  - Checks were properly posted to the general ledger and general ledger account selected appeared to be appropriate.
  - Check amount posted to the general ledger agreed to the electronic system scanned file.



**Internal Audit Report**  
**Life Insurance Company of Alabama**

**Internal Audit Summary Report**  
**Accounts Payable - Continued**

- From the sample selected, each significant control area for HCP disbursements was tested for proper compliance with the policy. Controls tested were as follows:
  - Check copy was located in the electronic system.
  - Documentation was in the electronic policy folder stating why there was a reimbursement and medical reports, if necessary, were included.
  - Payment was approved and agreed to policy application

**Key Highlights:**

- For the sample of general expenditures, LSP expenditures and HCP expenditures selected for the first six months of the 2014 year, no observations were noted.

**Suggestions for Improvement or Observations Noted:**

- During the first six months of the 2014 year testing, we noted no additional suggestions for improvements or observations.

**Suggestions for Improvement or Observations Noted in Previous reports:**

- Life Insurance of Alabama has modified their accounting policy for cash disbursements to incorporate previous suggestions, which were approved on May 5, 2014.



**Internal Audit Report  
Life Insurance Company of Alabama**

**Internal Audit Summary Report  
Investments**

Observations by Risk		
H	M	L
	X	

**Background:**

This test was an assessment of the internal controls related to investments. It was included in the internal audit plan due to the importance of having proper investment policies and procedures due to the value of the Company's balances.

**Scope and Approach:**

Our evaluation included the following procedures related to investments of the Company:

- Developed an understanding of the processes and controls in place for investments by obtaining the Company's investment policy.
- Agreed each month's postings from the brokerage statement activity to the general ledger from January 2014 to June 2014 and suggested any journal entries as necessary.

**Key Highlights:**

- There were no significant differences between the investment statements and the posting in the general ledger for the period from January 2014 until June 2014. Any monthly differences were timing differences that cleared the next month.

**Suggestions for Improvement or Observations Noted:**

- During the first six months of the 2014 year testing, we noted no additional suggestions for improvements or observations.

**Suggestions for Improvement or Observations Noted in Previous reports:**

- LICOA is currently working on investment suggestions noted in our previous report related to policies and procedures.



**Internal Audit Report**  
**Life Insurance Company of Alabama**

**Internal Audit Summary Report**  
**Payroll**

Observations by Risk		
H	M	L
	X	

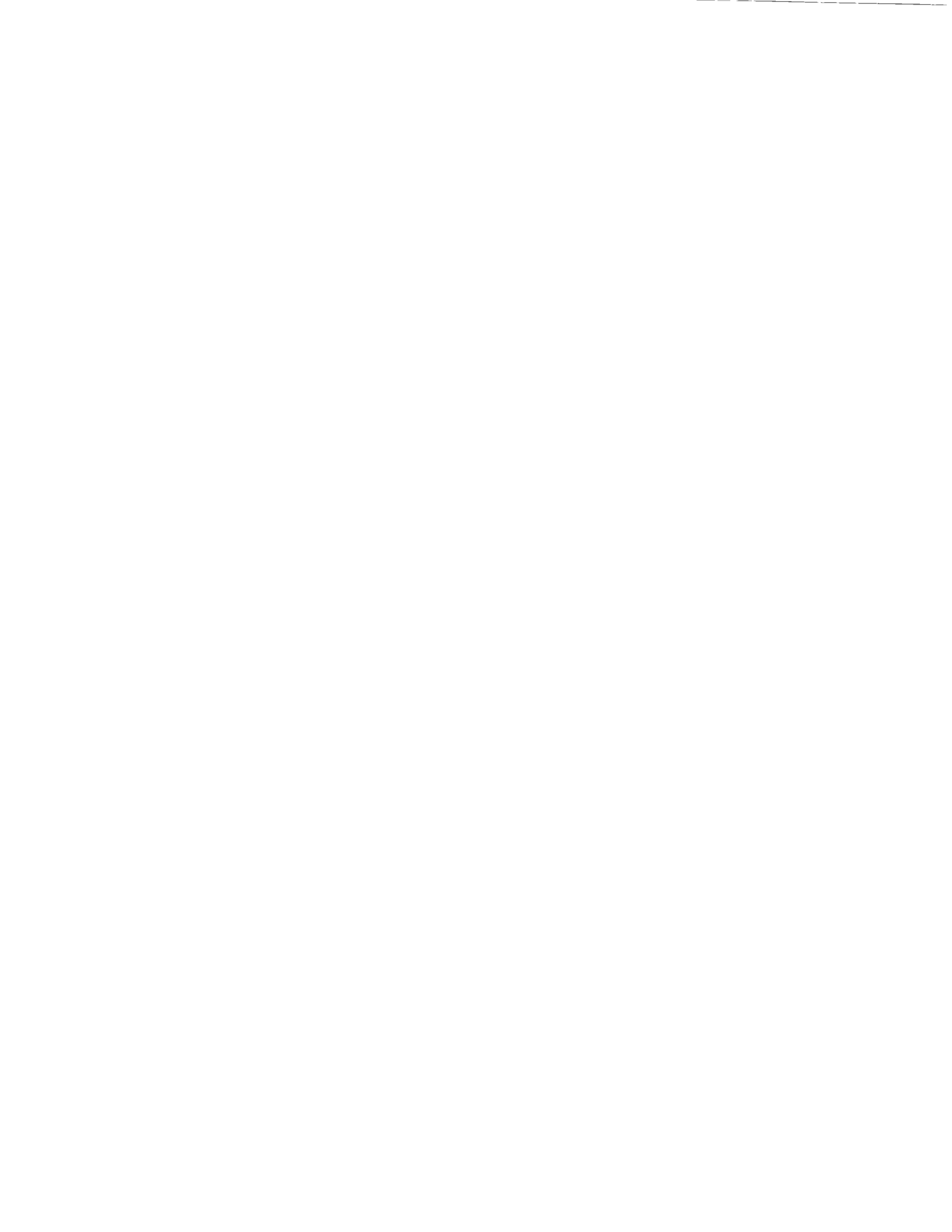
**Background:**

This test was an assessment of the internal controls related to payroll. It was included in the internal audit plan due to the importance of having proper payroll policies and procedures. This is an area that can be subject to external audits from federal, state or local agencies.

**Scope and Approach:**

Our evaluation included the following procedures related to payroll of the Company:

- Developed an understanding of the processes and controls in place for payroll.
- Received a list of all employees employed as of June 2014 and selected 30 employees for testing (not selecting employees from previous reports testing).
- The following items were tested in the employee files for the 30 employees selected:
  - Salary was approved in the employee file or minutes
  - Employee evaluations were in the file, if required
  - An I-9 form was completed if the employee was hired after the date this form was required
  - A copy of the employees drivers license was in the file, if required
  - A copy of the employee's social security card was in the file, if required
  - A signed confidentially agreement was in the file.
  - An application was in the file
  - E-verify was completed if the employee was hired after the requirement date
  - A new hire form was completed if hired after the requirement date
  - A form A-4 and W-4 was completed
- The following items were tested for the month of June 2014 payroll for the 30 employees selected:
  - The gross amount paid agreed to the approved payroll amount in the employee file
  - A time sheet was completed, signed by the employee, approved and hours agreed to the gross amount paid, if required
  - Any stick time or vacation time included in the payroll was approved
  - The total amount paid for the month of June agreed to the amount posted in the general ledger for June
- The following tax returns were examined and recalculated:
  - Alabama withholding for June 2014
  - 2rd quarter FUTA
  - 2rd quarter SUTA
  - June 2014 FICA payments
  - 2rd quarter 941
  - Gadsden occupational taxes for June





**Internal Audit Report**  
**Life Insurance Company of Alabama**

**Internal Audit Summary Report**  
**Payroll - Continued**

**Scope and Approach - Continued:**

- The total amount paid, net of withholdings, in June was traced to the June bank statements as properly clearing the bank account.
- For the payroll dated June 12, 2014, the following items were recalculated for the 30 employees selected:
  - FICA
  - City of Gadsden withholding
  - 401(k) withholding amount

**Key Highlights:**

- There were no exceptions noted during the testing of the employee files.
- There were no exceptions noted while testing the month of June 2014 payroll.
- There were no exceptions noted while recalculating the tax returns examined.
- There were no exceptions noted while agreeing the net amount paid for June to the bank statements.
- There were no exceptions noted during the recalculation of the FICA amounts withheld. During the recalculation of the City of Gadsden withholding of there were four employees that were not paying the full 2% withholding for city taxes. Per further inquiry, there is currently no documentation as to why these employees are not paying the full amount required.

**Suggestions for Improvement or Observations Noted in Previous reports:**

- Life Insurance of Alabama has modified their accounting policy for payroll to incorporate previous suggestions, which were approved on May 5, 2014.



**Internal Audit Report**  
**Life Insurance Company of Alabama**

**Internal Audit Summary Report**  
**Agent File Testing**

Observations by Risk		
H	M	L
		X

**Background:**

This procedure was tested to verify all required agent documentation is included in the agent's file.

**Scope and Approach:**

Our evaluation included the following procedures related to new agent file documentation:

- Received a listing of all new agents from the period of January 2014 to August 2014.
- Received a list of all required documents to be included in the agents file.
- Randomly selected 25 agents to test from the period provided.

**Key Highlights:**

- Verified the following items were in the agent's file for Individual Agents:
  - Application
  - E&O application or declination
  - Agents agreement
  - Signed schedule of commission
  - Copy of agent's license
  - State appointment fee
  - Copy of check or direct deposit information
- Verified the following items were in the agents file for Corporation or Partnership Agents
  - Application
  - E&O application or declination
  - Agents agreement
  - Signed schedule of commission
  - Copy of agent's license
  - State appointment fee
  - Copy of check or direct deposit information
  - W-9, or correct information on application (Partnership only)

**Suggestions for Improvement or Observations Noted:**

- There were no exceptions noted during this testing.



**Internal Audit Report**  
**Life Insurance Company of Alabama**

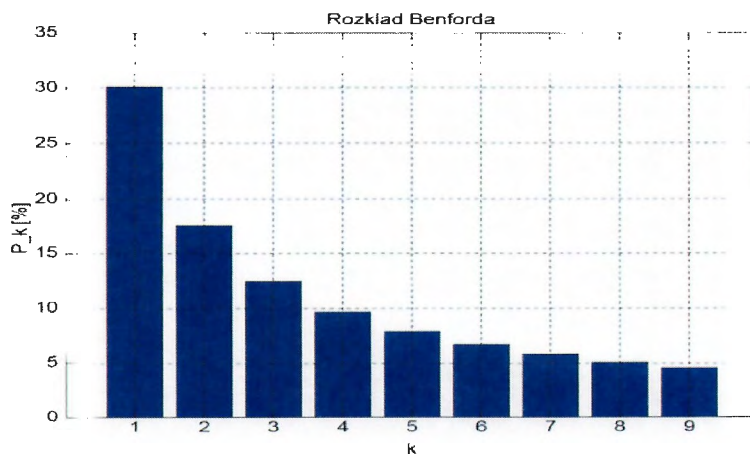
**Internal Audit Summary Report**  
**Benford's Law Testing**

Observations by Risk		
H	M	L
X		

**Benford's Law - Definition, History and Application**

***What is Benford's Law?***

Benford's Law, named for physicist Frank Benford, is the mathematical theory of leading digits. Specifically, in data sets, the leading digit(s) is (are) distributed in a specific, nonuniform way. While one might think that the number 1 would appear as the first digit 11 percent of the time (i.e., one of nine possible numbers), it actually appears about 30 percent of the time (see chart below). Nine, on the other hand, is the first digit less than 5 percent of the time. The theory covers the first digit, second digit, first two digits, last digit and other combinations of digits because the theory is based on a logarithm of probability of occurrence of digits.



***Accounting fraud detection***

In 1972, Hal Varian suggested that the law could be used to detect possible fraud in lists of socio-economic data submitted in support of public planning decisions. Based on the plausible assumption that people who make up figures tend to distribute their digits fairly uniformly, a simple comparison of first-digit frequency distribution from the data with the expected distribution according to Benford's Law ought to show up any anomalous results. Following this idea, Mark Nigrini showed that Benford's Law could be used in forensic accounting and auditing as an indicator of accounting and expenses fraud.



**Internal Audit Report**  
**Life Insurance Company of Alabama**

**Internal Audit Summary Report**  
**Benford's Law Testing - Continued**

***Distributions that can be expected to obey Benford's Law***

- Credit card transactions
- Purchase orders
- Loan data
- Customer balances
- Journal entries
- Stock prices
- Accounts payable transactions
- Inventory prices
- Customer refunds

***Distributions that would not be expected to obey Benford's Law***

- Where numbers are assigned: e.g., check numbers, invoice numbers
- Where numbers are influenced by human thought: e.g., prices set by psychological thresholds (\$1.99)
- Accounts with a large number of firm-specific numbers: e.g., accounts set up to record \$100 refunds
- Accounts with a built-in minimum or maximum
- Where no transaction is recorded
- Data sets with 500 or fewer transactions

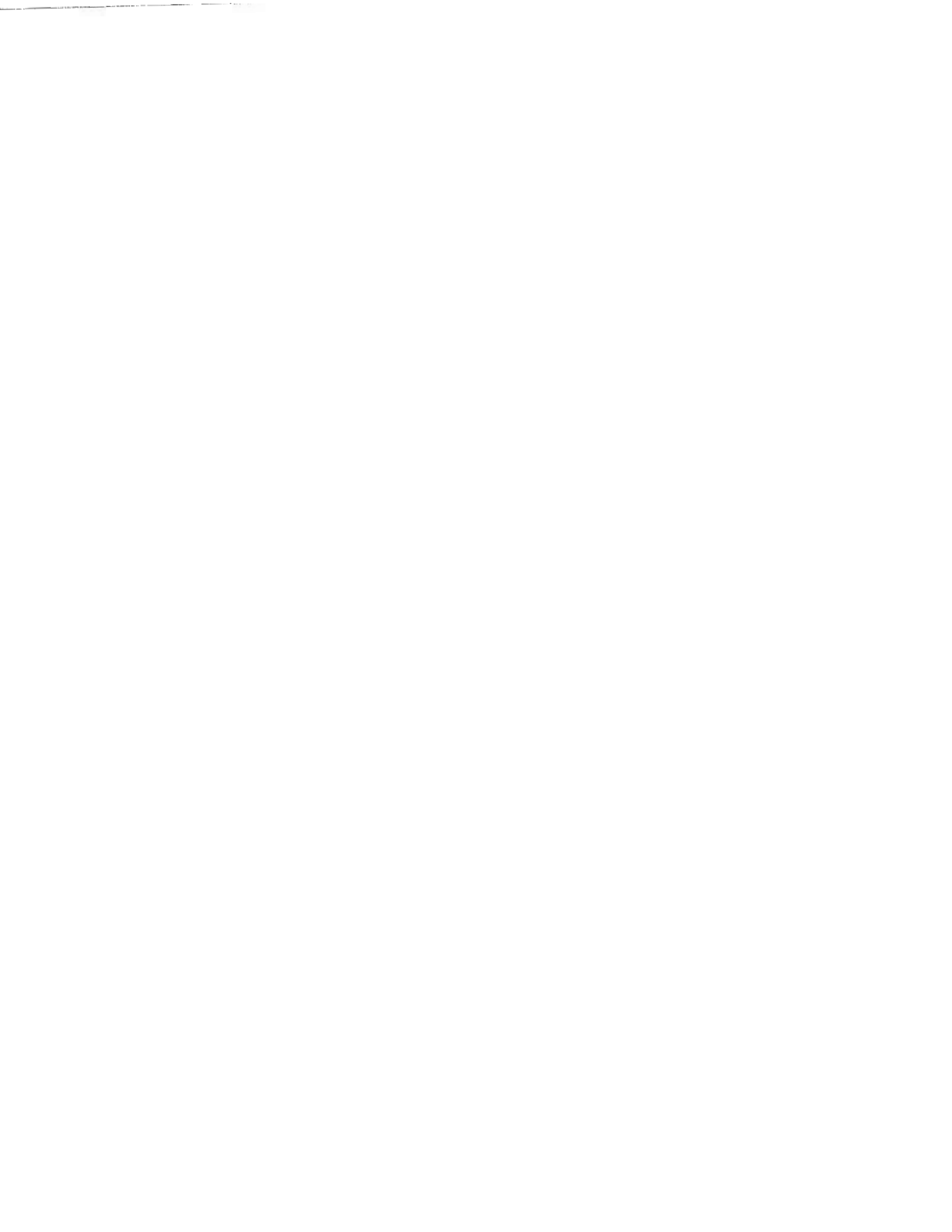
***Conclusion***

Benford's Law can recognize the probabilities of highly likely or highly unlikely frequencies of numbers in a data set. The probabilities are based on mathematical logarithms of the occurrence of digits in randomly generated numbers in large data sets. Those who are not aware of this theory and intentionally manipulate numbers (e.g., in a fraud) are susceptible to getting caught by the application of Benford's Law.

**Scope and Approach:**

Taking into consideration the disbursements that would not be expected to obey Benford's Law our evaluation included the following procedures related to general accounts payable:

- Received a listing of all general accounts payable checks written for the period of January 2014 until June 2014.
- Imported into a Benford's Law spreadsheets the check amount, see results below.



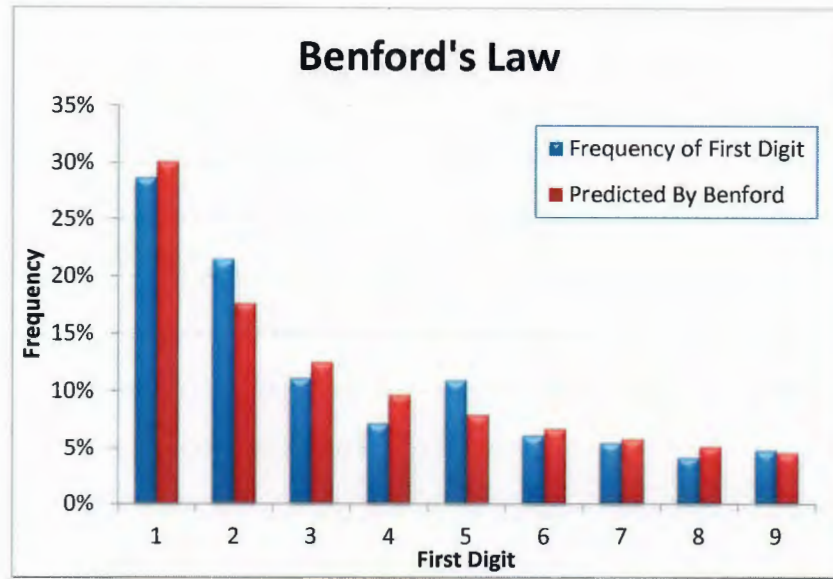


**Internal Audit Report  
Life Insurance Company of Alabama**

**Internal Audit Summary Report  
Benford's Law Testing - Continued**

**Key Highlights:**

**General Accounts Payable Checks Written from January to June 2014**



First Digit	Occurrence Of Digit	Frequency of First Digit at 6/30/14	Predicted By Benford
One	359	28.67%	30.10%
Two	269	21.49%	17.61%
Three	139	11.10%	12.49%
Four	90	7.19%	9.69%
Five	137	10.94%	7.92%
Six	77	6.15%	6.69%
Seven	69	5.51%	5.80%
Eight	52	4.15%	5.12%
Nine	60	4.79%	4.58%

**Suggestions for Improvement or Observations Noted:**

- There were no large unexpected deviations noted during this test.



**Internal Audit Report  
Life Insurance Company of Alabama**

**Summary of Suggestions for Improvements**

**Fixed Assets**

- No exceptions or suggestions noted.

**Accounts Payable**

- No exceptions or suggestions noted.

**Investments**

- There were no significant differences between the investment statements and the posting in the general ledger for the period from January 2014 until June 2014. Any monthly differences were timing differences that cleared the next month.

**Accounts Payable**

- There were no large unexpected deviations noted during this test.

**Payroll**

- There was no written documentation as to why certain employees are not paying the full 2% of the City of Gadsden withholding tax. This documentation must be in writing and adhere to the requirements set by the City.

**Benford's Law Testing**

- There were no large unexpected deviations noted during this test.