

**LIFE INSURANCE COMPANY  
OF ALABAMA**

INTERNAL AUDIT REPORT  
AS OF DECEMBER 31, 2013



**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
Cash receipts	7
Investments	8
Benford's Law testing	9
New policies or changes to policy testing	12
Tax return review	13
Travel and entertainment policy	14
Policy loan testing	15
Summary of suggestions for improvement	16

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

Listed below are the internal audit recommendations that were examined in the months of October 2013 through December 2013. 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	<b>Observations by Risk</b>		
	<b>High</b>	<b>Medium</b>	<b>Low</b>
1. Fixed assets			X
2. Accounts payable		X	
3. Cash receipts		X	
4. Investments		X	
5. Benford's Law testing	X		
6. New policies or changes to policies testing		X	
7. Tax return review		X	
8. Travel and entertainment	X		
9. Policy loan testing		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 third and fourth quarters of 2013 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.
- Reviewed the 2013 property tax return for accuracy and completeness.

**Key Highlights:**

- For the third and fourth quarter of 2013 expenditures described above, no observations were noted.
- For the verification of the subsidiary ledger to the fixed asset schedule for the third and fourth quarter, no observations were noted.
- For the review of the 2013 property tax return, no observations were noted.

**Suggestions for Improvement or Observations Noted:**

- During the third and fourth quarters of 2013 testing, we noted no additional suggestions for improvements or observations.

**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 last six months of the 2013 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 last six months of the 2013 year, no observations were noted.

**Suggestions for Improvement or Observations Noted:**

- During the last six months of the 2013 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 accounts payable suggestions noted in our previous report related to policies and procedures.

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

**Internal Audit Summary Report  
Cash Receipts**

Observations by Risk		
H	M	L
	X	

**Background:**

This test was an assessment of the internal controls related to accounts receivable/cash collections. It was included in the internal audit plan due to the importance of having proper controls over receipts that are deposited or mailed to the Company.

**Scope and Approach:**

Our evaluation included the following procedures related to cash receipts of the Company:

- Developed an understanding of the processes and controls in place for cash receipt by obtaining the Company's cash receipt policy. Develop an understanding of each key control the Company has over cash receipts.
- Obtain a detail of all receipts in account 112100 for the last six months of the 2013 year. Randomly selected 30 receipts to test for proper key control compliance. The sample included both ACH and check deposits.
- From the sample selected, each significant control area for cash receipts was tested for proper compliance with the policy. Controls tested were as follows:
  - Deposit amount was agreed to supporting documentation and checks deposited were footed with a control tape.
  - Summary control slips were scanned for electronic filing, deposited into the bank account and recorded in the general ledger.
  - ACH and check deposit amounts were traced to clearing the bank statement.
  - For deposits that were only checks, checks were footed to the deposit total.
- Reviewed two months bank reconciliations for proper reconciliation and review.
- One day's deposit detail was received that listed each policy holders account number and amount paid. This detail was footed and agreed back to the deposited amount. Each policy holder's payment was traced to being properly applied to their account balance in the general ledger system.

**Key Highlights:**

- For the sample of cash receipts selected for the last six months of the 2013 year, no observations were noted.
- During the review of the bank reconciliations there were no observations noted.
- During the testing of one day's deposit detail there were no observations noted.

**Suggestions for Improvement or Observations Noted:**

- During the last six months of the 2013 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 cash receipt suggestions noted in our previous report related to policies and procedures.

**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 July 2013 to December 2013 and suggested any journal entries as necessary.
- Agreed common stock and bond amounts per the brokerage statements to schedule D for the year ended December 2013.
- Analyze the bond holdings for any write downs based on a NAIC rating of 5FE or below. The lower of the cost of the bond or the fair market value was compared to the book value and evaluated for any additional impairment loss.

**Key Highlights:**

- There were no significant differences between the investment statements and the posting in the general ledger for the period from July 2013 until December 2013. Any monthly differences were timing differences that cleared the next month.
- There were no significance differences in the comparison of common stock and bond values from the brokerage statements to schedule D. There were some common stocks and bonds that are not held in a brokerage account. The example investment procedures manual and investment policy include notes on how to incorporate these types of investments into the Company's policies.
- Per review of the NAIC ratings of 5FE or below, we noted no additional suggestions for improvements or observations.

**Suggestions for Improvement or Observations Noted:**

- During the last six months of the 2013 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**

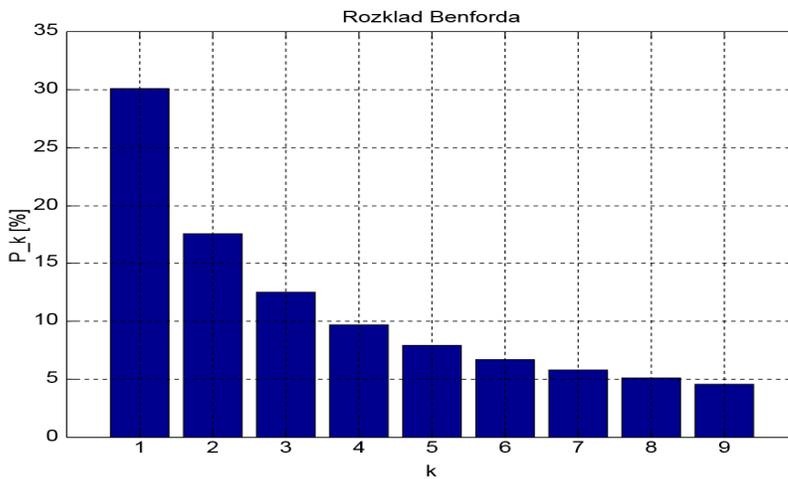
**Internal Audit Summary Report  
Benford's Law Testing**

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:

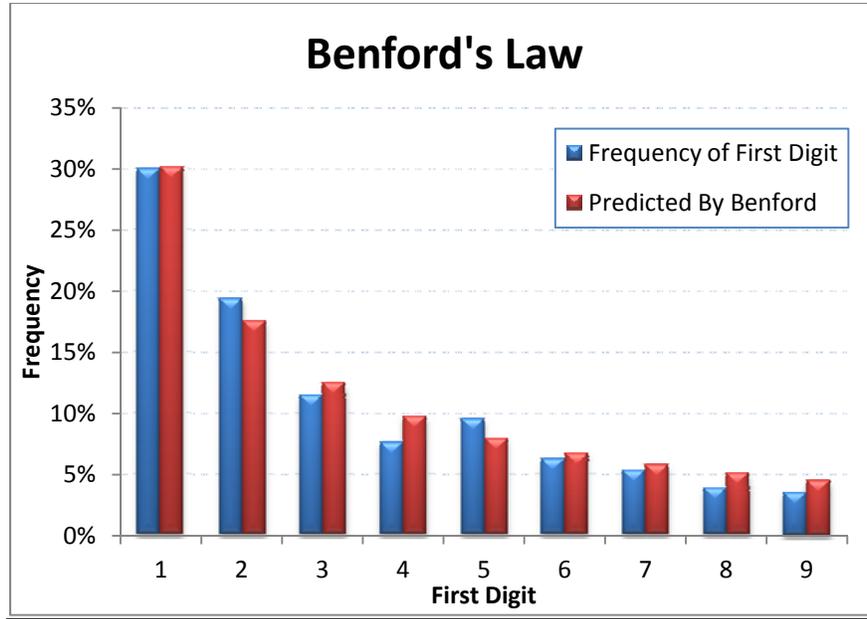
- Received a listing of all general accounts payable checks written for the period of January 2013 until December 2013.
- Imported into a Benford's Law spreadsheets the check amount, see results below.

**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 December 2013**



First Digit	Occurrence Of Digit	Frequency of First Digit at 12/31/13	Frequency of First Digit at 6/30/13	Predicted By Benford
One	1016	29.98%	27.38%	30.10%
Two	659	19.45%	18.33%	17.61%
Three	389	11.48%	15.05%	12.49%
Four	256	7.55%	9.61%	9.69%
Five	324	9.56%	9.37%	7.92%
Six	210	6.20%	6.53%	6.69%
Seven	180	5.31%	4.65%	5.80%
Eight	132	3.89%	4.41%	5.12%
Nine	120	3.54%	3.25%	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**

**Internal Audit Summary Report  
New Policies or Changes to Policies Testing**

Observations by Risk		
H	M	L
	X	

**Background:**

This test was an assessment of the internal controls related to new or changed insurance policies. It was included in the internal audit plan due to the importance of proper documentation and set up of insurance policies.

**Scope and Approach:**

Our evaluation included the following procedures related to new or changes to insurance policies of the Company:

- Developed an understanding of the processes and controls in place for insurance policies.
- Understand the different types of policies and changes
- Randomly select one month to test new or changes to policies.

**Key Highlights:**

- Randomly selected the month of November 2013 to test certain insurance policies. The following types and number of policies were tested for the month of November 2013.
  - Policies issued and paid - 30 policies tested
    - Application was included in the file
    - Any changes in the policy between completing the application and the policy becoming effective was in the file, if necessary.
    - The face amount of life insurance policies agreed between the application and what was recorded.
    - Commission was properly set up for the agent(s).
    - Medical records or other types of verification was included in the file, if necessary.

**Suggestions for Improvement or Observations Noted:**

- During the month of November 2013, we noted no additional suggestions for improvements or observations. There were no exceptions noted during our testing.

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

**Internal Audit Summary Report  
Tax Return Review**

Observations by Risk		
H	M	L
	X	

**Background:**

This procedure was an assessment of compliance with the Internal Revenue Service and various state agencies regarding the annual income tax liability. It was included in the internal audit plan due to the importance of complying with federal and state law for reporting taxable income and payment of income taxes.

**Scope and Approach:**

Our evaluation included the following procedures related to income tax return preparation of the Company:

- Review the 2012 Form 1120-L for completeness and accuracy.
- Review various 2012 state income tax forms required to be filed.
- Review the 2012 book-to-tax reconciliation for permanent and timing differences and review for completeness.
- Recalculate income tax liability for 2012.
- Agree amounts reported on the income tax return with amounts reported on the annual statement and trial balance for 2012.

**Key Highlights:**

- There were no observations were noted.

**Suggestions for Improvement or Observations Noted:**

- During the review of the 2012 income tax return, we noted no additional suggestions for improvements or observations.

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

**Internal Audit Summary Report  
Travel and Entertainment Policy**

Observations by Risk		
H	M	L
X		

**Background:**

This test was an assessment of the internal controls related to travel and entertainment. It was included in the internal audit plan due to the importance of having proper controls over the Company's travel and entertainment expenses. This risk for this control is considered high because of the external compliance violations that could occur with the IRS and adverse publicity if the policy is not followed properly.

**Scope and Approach:**

Our evaluation included the following procedures related to the travel and entertainment policy of the Company:

- Developed an understanding of the processes and controls in place for travel and entertainment by obtaining the Company's Travel & Business Expense Reimbursement Policy.
- Obtained a detail of all disbursements from accounts 185-Travel, 818-Entertainment, 817-Meals, 832-Club Expenses and 816-Lodging for the year ended 2013. All expenses posted to these accounts were tested for the following:
  - The expense was submitted for reimbursement no later than 30 days following the completion of a trip.
  - Overall documentation of the expense included names and identity of the individuals present, the business purpose, name and location of where the expense took place, exact amount and date of the expense and receipts for all expenditures
  - Mileage or gas reimbursement should include date and purpose of trip, location traveled to and from, mileage and receipts
  - Meal reimbursement should include name and identity of individuals present, business purpose, name and location of where the meal took place, receipt and date of the expense.
  - Miscellaneous expense reimbursement should include a copy of the receipt, names and identity of individuals present, business purpose and type of expense.
  - An expense report should be submitted by each employee requesting reimbursement and the report should be reviewed and approved.
  - The expense was reviewed for the correct account charged and the expense appeared appropriate.

**Key Highlights:**

- There were no significant items to report.

**Suggestions for Improvement or Observations Noted:**

- From the previous testing of this policy, there have been significant improvements.

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

**Internal Audit Summary Report  
Policy Loan Testing**

Observations by Risk		
H	M	L
	X	

**Background:**

This test was an assessment of policy loans on life insurance policies. It was included in the internal audit plan due to the importance of proper documentation and set up of insurance policies loans. It was also a request made by the external auditors to have a internal audit test for policy loans.

**Scope and Approach:**

Our evaluation included the following procedures related to policy loan testing:

- Developed an understanding of the processes and controls in place for policy loans.
- Selected 30 new policy loans from the year ended 2013 for testing and preformed the following steps:
  - Inspected a signature on the policy loan documentation of the policy holder.
  - Inspected the policy loan amount and policy effective date on the policy loan documentation and agreed it to the general ledger.
  - Noted the interest rate on the policy loan documentation agreed to the interest rate in the general ledger system.
  - Recalculated the capitalized interested in accordance with the terms of the loan, taking into account any loan repayments.
  - Agreed the loan balance per the report received to the loan balance on the general ledger.

**Key Highlights:**

- There were no items to report.

**Suggestions for Improvement or Observations Noted:**

- We noted no additional suggestions for improvements or observations.

**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.

**Cash Receipts**

- 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 July 2013 until December 2013. Any monthly differences were timing differences that cleared the next month.

**Benford's Law Testing**

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

**New Policies or Changes to Policies Testing**

- No exceptions or suggestions noted.

**Tax Return Review**

- No exceptions or suggestions noted.

**Travel and Entertainment**

- No exceptions or suggestions noted.

**Policy Loan Testing**

- No exceptions or suggestions noted.