

**LIFE INSURANCE COMPANY
OF ALABAMA**

INTERNAL AUDIT REPORT
AS OF JUNE 30, 2015



WILLIS BOATNER PUGH
CERTIFIED PUBLIC ACCOUNTANTS

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

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Listed below are the internal audit recommendations that were examined in the months of January through June 2015. 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	Observations by Risk		
	High	Medium	Low
1. Fixed assets			X
2. Accounts payable		X	
3. Investments		X	
4. Payroll		X	
5. Agent file testing			X
6. Benford's Law Testing	X		
7. Cash receipts		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
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**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 2015 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 2015 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 2015 testing, we noted no additional suggestions for improvements or observations.

**Internal Audit Report
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**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 2015 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.

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**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 2015 year, no observations were noted.

Suggestions for Improvement or Observations Noted:

- During the first six months of the 2015 year testing, we noted no additional suggestions for improvements or observations.

Suggestions for Improvement or Observations Noted in Previous reports:

- During the first and second quarters of 2015 testing, we noted no additional suggestions for improvements or observations.

**Internal Audit Report
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**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 2015 to June 2015 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 2015 until June 2015. Any monthly differences were timing differences that cleared the next month.

Suggestions for Improvement or Observations Noted:

- During the first and second quarters of 2015 testing, we noted no additional suggestions for improvements or observations.

**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 January 2015 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 required
 - A copy of the employees driver's 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 January 2015 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 January 2015 agreed to the amount posted in the general ledger for January 2015
- The total amount paid, net of withholdings, in January was traced to the February bank statements as properly clearing the bank account.
- For the payroll dated January 30, 2015, the following items were recalculated for the 30 employees selected:
 - FICA
 - City of Gadsden withholding
 - 401(k) withholding amount

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Key Highlights:

- There were no exceptions noted during the testing of the employee files.
- There were no exceptions noted while testing the month of January 2015 payroll.
- There were no exceptions noted while recalculating the tax returns examined.
- There were no exceptions noted while agreeing the net amount paid for January to the bank statements.
- There were no exceptions noted during the recalculation of the FICA amounts withheld.
- There were no exceptions noted during the recalculation of the City of Gadsden withholding.
- There were no exceptions noted during the recalculation of the 401(k) withholding amounts.

Suggestions for Improvement or Observations Noted in Previous reports:

- During the January 2015 testing, we noted no additional suggestions for improvements or observations.

**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 2015 to May 2015.
- Received a list of all required documents to be included in the agents file.
- Randomly selected 20 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.

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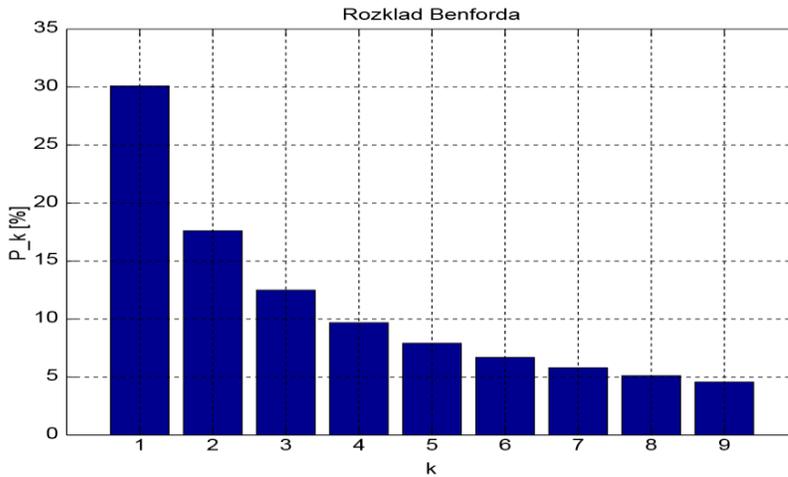
**Internal Audit Summary Report
Benford's Law Testing**

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.

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**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:

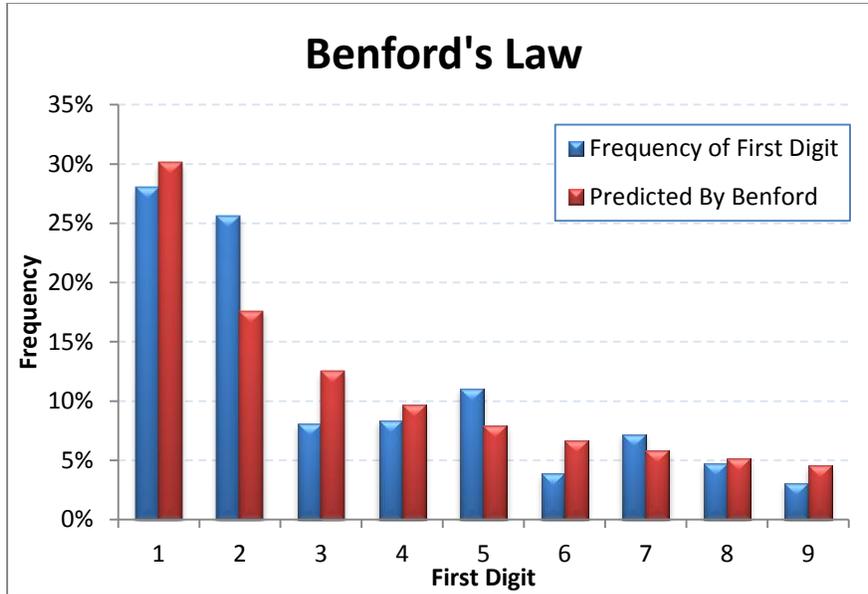
- Received a listing of all general accounts payable checks written for the period of January 2015 until June 2015.
- Imported into a Benford's Law spreadsheets the check amount, see results below.

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

Key Highlights:

General Accounts Payable Checks Written from January to June 2015



First Digit	Occurrence Of Digit	Frequency of First Digit at 6/30/15	Frequency of First Digit at 12/31/14	Predicted By Benford
One	437	28.03%	27.53%	30.10%
Two	400	25.66%	22.68%	17.61%
Three	126	8.08%	10.62%	12.49%
Four	130	8.34%	8.75%	9.69%
Five	172	11.03%	11.81%	7.92%
Six	60	3.85%	3.40%	6.69%
Seven	112	7.18%	6.63%	5.80%
Eight	74	4.75%	4.33%	5.12%
Nine	48	3.08%	3.23%	4.58%

Suggestions for Improvement or Observations Noted:

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

**Internal Audit Report
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**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 2015 year. Randomly selected 60 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 each six months 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 2015 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 2015 year testing, we noted no additional suggestions for improvements or observations.

Suggestions for Improvement or Observations Noted in Previous reports:

LICOA has approved a proposed check procedure related to our previous suggestions, which will be tested next quarter.

**Internal Audit Report
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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 2015 until June 2015. Any monthly differences were timing differences that cleared the next month.

Payroll

- No exceptions or suggestions noted.

Agent File Testing

- No exceptions or suggestions noted.

Benford's Law Testing

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

Cash Receipts

- No exceptions or suggestions noted. Will test new procedures in the next quarter.