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AIG, Audit Committees, Legends, and P/E Ratios

The Tao of Hank, Part 1

On May 2 we published an article about AIG's audit-committee report. Specifically, we noted that the report's elusive, equivocal verbiage made it little more than an extensive disclaimer—exactly the opposite of what an audit-committee report should be.

Audit-committees reports are a dull subject. So dull, in fact, that to the best of our knowledge, no one else in the world had written about the disclaimers in AIG's report. (In fairness to AIG, a number of other large companies used the same evasive language.)

Our article caused a stir among insurance cognoscenti, and then created something of a commotion when *The Economist* had the good judgment to pick up our story. Although we received positive feedback from many subscribers, we were amazed that some subscribers—including respected analysts and insurance-company presidents—told us that our observations were out of line. Audit committees are not worthy of so much attention, they said, and it reflected poorly on us to be making a big deal about them.

It seems remarkable that less than three months ago learned folks still believed that the numbers in companies' financial statements were *sanctified* just because CEOs and the accountants they hired set those numbers in type.

Of course, any belief in the inviolability of corporate accounting disappeared on June 25, when WorldCom's numerical innovations became known. That audited financial statements can be manipulated so that losses become profits is nothing new. Nor is it new that many companies are run by rapacious scoundrels.

During bull markets investors happily ignore blatant warnings. In our August 1999 issue, for example, we commented on InsWeb, the Internet insurance marketplace that had just gone public and commanded a $1.5 billion market cap, even though it had virtually no revenues and expected to "incur substantial operating losses for the foreseeable future."

Thanks to the Securities Act of 1933, there was no reason for any investor to lose a penny investing in InsWeb. The Securities Act—also known as the "truth in securities" law—requires issuers to provide investors with meaningful disclosure. InsWeb dutifully carried out its responsibility, and warned investors about the toxicity of its common stock. The "risk factors" section of its prospectus came in at 8,477 words, which may be a record. (InsWeb's stock is now down 99%.)

In our May 2 article, we questioned whether the failure of AIG's audit committee to express an unqualified opinion about the company's accounting would cause AIG's stock to trade at a lower multiple of earnings. (AIG stock was then $71.51; it is now $53.38.)

Before we delve further into AIG's accounting and audit-committee report, the SEC, and related subjects, we want to make sure that readers put our thoughts in perspective. Over the years we've written about a dozen articles on AIG. We've commented on its success, complexity, mergers and acquisitions, and p/e ratio. In late 1994 we wrote that AIG's stock was cheap and that we'd bought it. (We sold it several years later.) In 1998 and 2000, we noted that AIG's p/e ratio was so high that the stock price had scant margin of safety. We've also written about companies that AIG has subsequently acquired (SunAmerica), and about AIG's mysterious offshore reinsurance transactions (Coral Re).

There are many reasons to write about AIG, not the least being that it is the largest, most important, and greatest worldwide insurance organization. AIG, by virtue of its size, scope, "AAA" rating, and nature is a fabulous (and fabulously complex) company. It is not, however,

AIG's Audit Committee Report: Caveat Emptor

The key paragraph in AIG's audit-committee report follows. Italics have been added for emphasis.

The members of the [Audit] Committee are not professionally engaged in the practice of auditing or accounting and are not experts in the fields of accounting or auditing, including in respect of auditor independence. Members of the Committee rely without independent verification on the information provided to them and on the representations made by management and the independent accountants. Accordingly, *the Committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and financial reporting principles or appropriate internal controls* and procedures designed to assure compliance with accounting standards and applicable laws and regulations. Furthermore, *the Committee's considerations and discussions referred to above do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that AIG's auditors are in fact "independent."*

easy to understand, and cannot be fully understood by an outsider. (Actually, it cannot be *fully* understood by an insider, either, but that's probably true of every giant multinational.) AIG's history—which we've been researching for some time—is a story of entrepreneurship, daring, audacity, internationalism, and capitalism. It is a remarkable feat that in 40 years or so, AIG, which was a loosely-knit group of foreign underwriting agencies, life insurers, and second-rate domestic insurers—managed to eclipse, by a wide margin, the titans of yesteryear: Aetna, CNA, Connecticut General, Continental, The Hartford, The Home, INA, Metropolitan, Prudential, Travelers, and USF+G. Today, AIG is worth much more than all these combined.

Hank Greenberg, who has led AIG for the last 33 years, is admired, respected, and feared. Greenberg, despite his 77 years, is not mellow; he's intense and competitive. He's also charming, charismatic, funny, and deeply concerned about every aspect of his business. He's filled with energy and enthusiasm, and, despite his involvement with big issues around the globe, seems easily aggravated by details so small you wouldn't expect the CEO of one of the world's largest companies to pay attention to them. Greenberg's attention to minutia does not seem to have hurt his company's results. Perhaps it has even contributed to his success.

If there's anyone in the industry who can be considered a living legend, it is Greenberg. This status was dramatized at *Schiff's Insurance Conference* in April, at which he was the first speaker. After Greenberg had talked for almost an hour without notes, he was asked a good question: "How do you spend your day?" He gave an answer that interested our hardboiled, skeptical audience. (We won't repeat it; you just had to be there.) It is unimaginable that the same audience would exhibit much curiosity about how other insurance CEOs spend their days.

Why do insurance mavens care what Greenberg does all day? We care because, in an industry where it's so easy to go awry and so hard to excel, AIG has accomplished what no other company has. Watching Greenberg's performance is akin to watching a sleight-of-hand artist who makes cards appear and disappear. Although you know the legerdemain isn't magic—it's the result of practice and hard work—it seems like magic.

"When the legend becomes fact, print the legend," says the newspaper editor at the end of John Ford's elegiac Western, *The Man Who Shot Liberty Valance*. But separating legends from facts is often impossible. "Once a newspaper touches a story, the facts are lost forever," Norman Mailer wrote, "even to the protagonists." So we all read about the Greenberg of legend: the World War II and Korean War veteran who's tough, hard-driving, combative, and intolerant of failure. There is, of course, much more to him.

Greenberg is a disciplined man. He is lean and fit, and his posture is perfect. He is careful about what he eats and exercises regularly. He appears to have little interest in the trappings of extreme wealth. He doesn't have the fanciest homes or the biggest art collection, and his name doesn't appear in society columns. He wears conservative suits, button-down shirts, and an inexpensive watch. He loves to ski and play tennis. He can recall names and details from 50 years ago.

Schiff's has gotten to know many insurance CEOs reasonably well over the years. One could say that they all have a reason to talk to us: to attempt to influence us or to get on our good side (the presumption being that we actually have a good side). Out of all those CEOs, we have never met anyone who has been as open as Greenberg.

And yet, there are many Wall Street analysts who are terrified of him because they believe that *if he wanted to, he could cause them to be fired*. This may or may not be true, but if it is widely believed, then isn't the effect the same as if it were true?

Many of Greenberg's competitors—sane, successful men—are also afraid of pissing him off because—mind you, this is just one example—*he controls the New York Department of Insurance and could get them tied up in a regulatory morass*. Whether he really controls the department is irrelevant to the *perception* that he does. The effect on his competitors is the same. (When we discussed this with him, Greenberg scoffed at the notion that he controls the insurance department, and grumbled something about how long it takes AIG to get filings through.)

The foregoing brings us back to our May 2 article about AIG's audit-committee report, and our musings about the effects that issues of complexity and transparency have on AIG's stock price and p/e ratio.

The gist of our article was that AIG's audit committee, in its reports for the years ending 2001 and 2000, used atypical—and in our view, inappropriate—language: "The [audit] committee's oversight does not provide an independent basis to determine that AIG's management has maintained appropriate internal controls and procedures," stated AIG's audit-committee report. "The committee's considerations…do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards…*or that AIG's auditors are in fact 'independent.'*" [Emphasis added.]

The audit-committee's verbiage prompted us to pose two questions: 1) If AIG's audit committee (which, like all audit committees, is comprised of "independent" directors), can't express an unqualified opinion about AIG's accounting, doesn't it make sense that the public's faith in AIG's accounting should be somewhat diminished, and 2) if the public's faith is diminished, isn't it reasonable to expect AIG's stock to trade at a lower multiple of earnings than it would otherwise?

The first question is more important, because if the answer to it is "No," the second question becomes moot. Since it is a *fact* that AIG's audit-committee report contains caveats that render it virtually meaningless, we are faced with the inevitable question: Will these caveats diminish the public's faith in AIG's accounting?

There are reasons why one could answer "No": 1) Some other large companies use identical language, and, perhaps, hundreds use similar language; 2) The caveats are there for legal reasons; 3) The financial statements are prepared by management and audited by outside accountants; 4) The audit committee merely plays an "oversight" role. Assurance about the financial statements comes from the outside accountants in the "Report of Independent Accountants" and from AIG's management in the "Report of Management's Responsibilities;" 5) The audit committee can't be expected to provide assurance that the financial statements conform to GAAP or that the accountants are actually independent; 6) The audit committee is comprised of respectable people; and, 7) One would have to be out of his mind to think that anyone gives a damn about audit-committee reports.

These responses are reasonable enough, but we continue to doubt they'll satisfy every thoughtful, intelligent investor. If that is correct, then it's reasonable to assume that the caveats in AIG's audit-committee report have *some* effect on AIG's p/e multiple, even if that effect is slight. We don't know of any way to estimate what the effect will be or how to measure it.

As we mentioned in our previous article, in the post-Enron (and now, post-WorldCom) era, accounting minutia are of greater concern to many. By itself, AIG's audit-committee report is not a smoking gun. However, no one views *anything* by itself. The audit-committee report is one piece of a large puzzle. On one hand there's AIG's great history and strong businesses; on the other hand there's the company's inherent "black-box" complexities. Investors, for good reasons, are now more wary of complexity—and of things they don't understand.

AIG's caveat-filled audit-committee report is a farce, and AIG's board made a mistake when it accepted it. Perhaps it didn't understand that the times were changing and AIG's stock, which had traded at an unusually high p/e multiple for many years, was vulnerable. We wrote numerous times over the last four years that the risk of buying AIG's shares at a stratospheric p/e multiple outweighed the reward.

AIG's p/e multiple, which had been a single-digit figure for much of the 1970s and 1980s, rose sharply after 1988, which boosted the increase in AIG's stock price over the years. (The p/e multiple eventually peaked at about 42—a figure that left virtually no margin of safety.) AIG's stock has been declining for a year and a half. Viewed another way, the company's p/e multiple has been contracting.

Beginning next month, Hank Greenberg will file a sworn written statement with the SEC personally attesting that AIG's financials are materially truthful. (Officers at 945 large companies must file the same statement for their companies.)

Beginning next year, we expect AIG's audit committee to drop the caveats and disclaimers in its report. While that won't make AIG easier to analyze, it will make the audit committee more responsible for its work. That can only be a good thing.

To be continued. Part 2 of this article will probably appear early next week.

A couple of months ago, when discussing AIG with Greenberg, we said that when valuing the company we put a lower multiple on earnings from GICs than on other earnings. Greenberg's response: "I don't think you should value the company based on the components of its earnings. It's the diversification of earnings that's important. That's what makes AIG. It's the totality...not the pieces. AIG is a great company with an unparalleled franchise. You couldn't put it together today if you wanted to."

We don't use the same method to value AIG that Hank does, but we do agree with his sentiments. Although we don't think AIG's stock is a bargain, in the interest of full disclosure we must admit that we became a shareholder yesterday. We paid $49 per share—14 times this year's projected earnings. That's higher than we like to pay, and it gives our investment a more speculative characteristic than we ordinarily prefer.

Unlike stockbrokers, who rate a stock a "buy" and then list a much higher target price, we tend to think about how much lower a stock must go before we buy more. Right now we're planning to double our investment when AIG hits 39. Of course, we may change our opinion. If we do, it is highly unlikely that we will notify you at that moment.

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