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SCHIFF'S

INSURANCE OBSERVER

August 16, 2002
Volume 14 • Number 11

AIG to Change Audit-Committee Report

Don't Look Back

"Your mother is responsible for your fear of Generally Accepted Accounting Principles."

American International Group can run but it can't hide, and Hank Greenberg knows that. Times have changed, and AIG is trying to change with them. Thus, in the new corporate spirit of openness and transparency, AIG has held its first quarterly conference call to discuss its earnings, created an office of the chairman, made two of its so-called "independent" directors *more* "independent," ran an all-day meeting for investors, provided new disclosures in its annual report and 10-K, and announced that it will expense stock options beginning next year.

Most of these changes are cosmetic—form over substance—but they're positive and make good sense for AIG which, due in part to its complexity and inherent impenetrability, is now viewed with considerably more skepticism than it has been for many years.

For our money, however, the most significant change that AIG will make is one that hasn't been reported: it will alter its audit-committee report in next year's proxy statement.

For the past two years AIG's board of directors has accepted—and fobbed off on shareholders—audit-committee reports that were evasive, equivocal, and not in keeping with the spirit of last year's SEC requirement that an audit-committee report be included in public companies' proxy statement.

Beginning next year, AIG's audit-committee report will, apparently, contain a positive opinion about AIG's financial reporting rather than a disclaimer designed to insulate AIG's directors from responsibility. Greenberg, who is concerned with transparency and appearances for many reasons (not the least being that the *perception* that there's something to hide affects the company's stock price and access to capital), told us he will "insist" upon a better audit-committee report. "I don't think anyone paid much attention to it," he said, referring to the myriad qualifications in AIG's audit-committee report. "We relied on outside counsel. In retrospect, that was a mistake." Greenberg, who's been in the insurance business for 50 years, didn't become The Great Greenberg by letting mistakes go uncorrected.

For those who don't recall the May 2 and July 25 issues of *Schiff's*, we'll provide a brief reminder: AIG's audit-committee report, as it is now written, is not an endorsement of the company's accounting; rather, it's a legal disclaimer for the audit committee. "The [audit] committee's oversight does not provide an independent basis to determine that AIG's management has maintained appropriate internal controls and procedures," states the audit-committee report of the world's most valuable insurance organization. "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."

If the audit-committee of the company that believes that the greatest risk is not taking one can't state that AIG's financial statements conform with GAAP, then who needs the audit committee? If the audit-committee can't determine whether or not AIG's auditors are "independent," then the members of the audit committee should be replaced by people who can make such a determination.

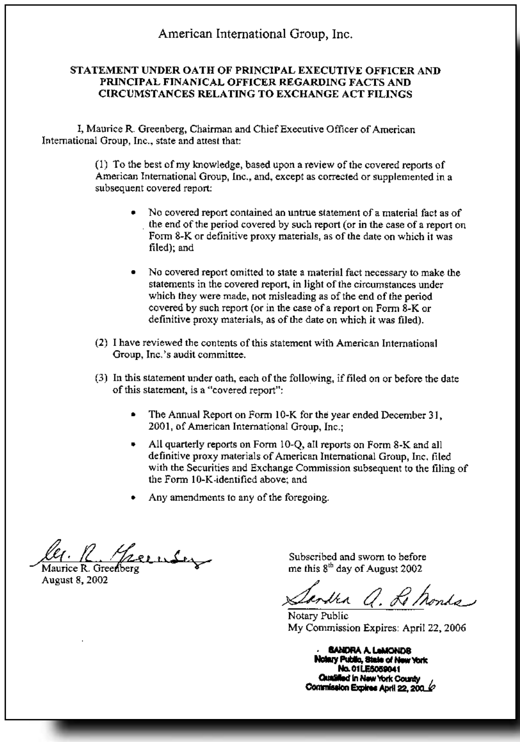
That AIG, which is worth approximately $175 billion, will change its audit-committee report is a testament to the changing times. If the stock-market boom at the end of the last millennium qualified as a "new era," then the present climate of skepticism and corporate accountability is another new era. (The future, of course, is comprised of nothing but "new eras." They come and go all the time.)

After our May 2 article, we received complaints from some subscribers, including securities analysts who were recommending AIG's stock. (According to First Call, 22 of 23 analysts covering AIG rate it a "buy.") *Schiff's* was destroying public confidence, we were told, by writing about AIG's audit-committee report, especially during a time when the market was so volatile. We were also told that the audit committee is *only* an overseer: it hires the accountants but doesn't *really* have access to financial information.

A company's board of directors and audit committee have broad authority. The audit committee can meet alone with the internal financial people and the outside accountants, request whatever information it wants, conduct investigations, hire outside counsel, and bring in other accountants or experts if it needs to. (AIG's audit committee met seven times in 2000 and four times in 2001.)

We were also told that the audit committee shouldn't *really* be held accountable because, in the end, it relies on management and the auditors. But that argument leads to a web of deniability in which no one is accountable: the audit committee relies on management and the accountants, the accountants rely on management, management relies on the accountants, management's financial statements are approved by the board, the board relies on the audit committee, the audit committe relies on management and the accountants...

A company's board of directors should serve as an overseer; it hires (or fires) the CEO, and approves budgets, major capital expenditures, acquisitions, divestitures and many other corporate actions. It has been said that a director should be a skeptical ally of management. Directors should have knowledge, background, and skills sufficient to allow them to perform their job well. Furthermore, they should devote enough time to carry out their responsibilities, and should have the temperament to speak out and act independently, regardless of the consequences.


American International Group, Inc.

STATEMENT UNDER OATH OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANICAL OFFICER REGARDING FACTS AND CIRCUMSTANCES RELATING TO EXCHANGE ACT FILINGS

I, Maurice R. Greenberg, Chairman and Chief Executive Officer of American International Group, Inc., state and attest that:

(1) To the best of my knowledge, based upon a review of the covered reports of American International Group, Inc., and, except as corrected or supplemented in a subsequent covered report:

- No covered report contained an untrue statement of a material fact as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed); and
- No covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed).

(2) I have reviewed the contents of this statement with American International Group, Inc.'s audit committee.

(3) In this statement under oath, each of the following, if filed on or before the date of this statement, is a "covered report":

- The Annual Report on Form 10-K for the year ended December 31, 2001, of American International Group, Inc.;
- All quarterly reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials of American International Group, Inc. filed with the Securities and Exchange Commission subsequent to the filing of the Form 10-K-identified above; and
- Any amendments to any of the foregoing.

Maurice R. Greenberg
August 8, 2002

Subscribed and sworn to before me this 8th day of August 2002

Notary Public
My Commission Expires: April 22, 2006

SANDRA A. LeMONDS
Notary Public, State of New York
No. 01LE5059041
Qualified in New York County
Commission Expires April 22, 2006

Hank Greenberg complies with SEC Order No. 4-460

In practice, many directors don't meet this standard. Boards are filled with yes-men (and token yes-women) who let CEOs do what they want. In return for doing little, directors get paid well, make useful business connections, and gain status that generally benefits them in some way or other. This is how it goes at most public companies, mutual funds, and money-market funds. Although directors are elected by the shareholders, shareholders don't usually get involved. This is particularly true of mutual funds, which rarely make an issue of corporate governance, probably because they employ the same corporate structure as the companies they invest in.

We approve of AIG's change regarding its audit-committee report, but won't give a giant company a pat on the back because it decides to operate in a more forthright manner. (Also, we don't know exactly what changes AIG will make. The new audit-committee report will appear in the proxy statement, which will be distributed next April.) Shareholders and policyholders should expect the highest standards from AIG.

Although Hank Greenberg gave little or no thought to AIG's audit-committee report before we wrote about it, the same cannot be said about every member of the audit committee. Before proceeding, however, a brief history of why audit-committee reports began appearing in proxy statements in 2001 is in order.

In 1895 the New York Stock Exchange *recommended* that listed companies give their shareholders an annual report that included a balance sheet and income statement. Five years later this became a requirement for companies seeking a new listing. The Securities Act of 1933 and the Securities Exchange Act of 1934 mandated important disclosure and created a regulatory authority—the Securities and Exchange Commission. Over the next 68 years, shareholders, activists, gadflies, corporate raiders, legislators, and regulators would seek to make companies more accountable, and the accounting they used more acceptable. It was not until 1977, however, that the New York Stock Exchange required listed companies to have an independent audit committee comprised of "outside"—but not necessarily "independent"—directors.

Change often happens slowly then suddenly, and nothing can permanently alter investors' mood swings between greed and fear. But disclosure, reform, and good regulation can protect intelligent investors and increase the markets' efficiency.

On September 28, 1998, Arthur Levitt, then chairman of the SEC, gave a speech entitled "The Numbers Game" in which he discussed the widespread practice of earnings management. "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common-sense business practices," he said. "Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

"As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion.

"Many in corporate America are just as frustrated and concerned about this trend as we, at the SEC, are. They know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud. A gray area where the accounting is being perverted; where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company."

Levitt noted that the pressure for companies to meet analysts' expectations was corrupting peoples' behavior. "Almost everyone in the financial community shares responsibility for fostering a climate in which earnings management is on the rise and the quality of financial reporting is on the decline," he said. "Corporate management isn't operating in a vacuum. In fact, the different pressures and expectations placed by, and on, various participants in the financial community appear to be almost self-perpetuating.

"This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way."

Levitt described six practices used to manipulate or "manage" earnings: accounting hocus-pocus, "big-bath" charges, creative acquisition accounting, miscellaneous cookie-jar reserves, materiality, and revenue recognition.

He also outlined a plan of action to stem the abuses, the final item of which was strengthening the audit-committee process. "Qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest," he said.

Levitt announced that as part of a comprehensive effort to address earnings management, the New York Stock Exchange (headed by Richard Grasso), and the National Association of Securities Dealers (headed by Frank Zarb), had agreed to sponsor a "blue-ribbon" panel which would "develop a series of far-ranging recommendations intended to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability."

On February 8, 1999 the 11-member panel released its report, which contained numerous reforms and recommendations. Although several members of the panel made comments in an accompanying press release, we'll quote one member, Frank Zarb, because, two years later, he joined AIG's board, and became a member of its audit committee the following month. "Corporate governance is a key issue facing the management of publicly traded companies," Zarb said. "The role of audit committees is critical to that process. These recommendations are a thoughtful product of the expertise in this area."

The panel's numerous recommendations included a written charter for the audit committee, public disclosure of audit-committee activities, and an annual letter from the audit committee to shareholders.

According to the blue-ribbon panel, the audit committee was the most important participant in the financial reporting process. "A proper and well-functioning system exists," the panel said, "when the three main groups responsible for financial reporting—the full board including the audit committee, financial management including the internal auditors, and the outside auditors—form a 'three-legged stool' that supports responsible financial disclosure and active and participatory oversight. However, in the view of the [panel], *the audit committee must be 'first among equals'* in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process." [Emphasis added.]

The blue-ribbon panel recommended that the audit committee, in its annual report, state that it "believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects." This recommendation seems so basic that it's hard to believe it wasn't already a requirement.

The SEC, perhaps feeling outside pressure from the business community, did not adopt this recommendation. It noted a concern about exposing audit-committee members to additional liability, and mentioned that some commenters averred that it might be difficult for companies to find people willing to serve on audit committees if the audit-committee members were exposed to additional liability. The SEC's final rule stated that "because of concerns about liability, we did not propose the disclosure requirement recommended by the Blue Ribbon Committee, but instead proposed that the audit committee indicate whether, based on its discussions with manage-

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ment and the auditors, its members became aware of material misstatements or omissions in the financial statements."

Thus, the audit committee is not required to say that a company's financial statements conform to GAAP; it need only has to say that it isn't aware of material misstatements. Due to the watered down regulations, a company can issue an evasive, equivocal audit-committee report yet still comply with the SEC guidelines. AIG has done this for the past two years.

The recent financial and accounting scandals have produced a radical change in attitude. Regulators, legislators, institutions, and even the president of the United States are now saying they're going to do something. The NYSE recently sent out a 28-page magazine called *Your Market*, one of the purposes of which was to help restore investor confidence. "Should you have faith in public companies?" asks the headline of one article. "Without hesitation, the answer is yes," it replies. (The NYSE does not say why it failed to tell investors that they *shouldn't* have had so much faith a couple of years ago, when the market was fifty percent higher.)

President Bush, a hands-off, free-market sort of guy, is also concerned with "corporate responsibility," and talks of hunting down corporate evildoers and putting them behind bars.

The SEC now requires CEOs and CFOs of large companies to issue sworn written statements affirming that they haven't cooked their companies' books.

Speaking about AIG's recent decision to expense stock options, Greenberg told *The Wall Street Journal* that "the perception out there today, erroneously, is that not expensing stock options is wrong. *The perception is more important than the substance.*" Since outsiders can't audit AIG's books, they will always be unable to get all the substance they would like. They will have to settle for perception.

Hank Greenberg's sworn written statement (see page 2) says that AIG's SEC filings do not contain an untrue statement of a material fact, do not omit any material facts, and are not misleading.

It also says that he has reviewed his statement with AIG's audit committee. ■

The blue-ribbon panel's audit-committee report is at http://www.nyse.com/content/publications/NT00006286.html. The SEC's final rules are at http://www.sec.gov/rules/final/34-42266.htm#P122_33770.