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Enron-o-Mania and the Insurance Industry

Accounting and Propriety, Part 2

How "independent" should an insurance company's auditor be? For instance, should accounting firms lobby legislators to pass legislation that would benefit their audit clients?

Before pondering this, we'd like to present a defense of the accounting profession: accountants are no more crooked than stockbrokers, lawyers, investment bankers, insurance brokers, or Fortune 500 CEOs.

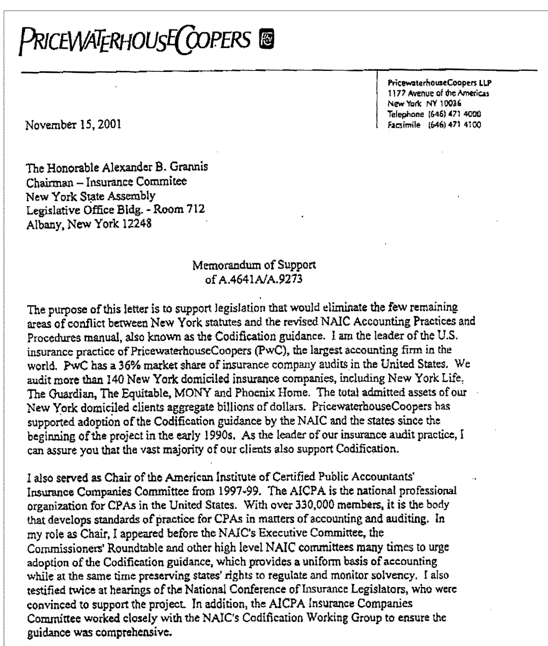
When it comes to finance and financial reporting, there's often a fine line between propriety and impropriety. Companies hire lawyers, accountants, bankers, and consultants to get them as close to that line as possible.

If Enron, for example, phonied its numbers, it did so for a reason: to provide Wall Street with the reported earnings it had come to expect. Even if the "earnings" were an optical illusion, Wall Street *wanted* to believe—despite numerous red flags—and this enabled Enron's executives to make scads of money selling shares into an inflated market.

Aside from its size and scope, though, Enron isn't all that unusual. In the insurance industry, companies routinely manipulate their numbers, and CEOs invariably find ways to siphon more money for themselves from shareholders, or, in the case of mutuals, from policyholders. The problem is systemic and will never be fixed. But it can be improved, and there's nothing like a juicy scandal—and the hearings, lawsuits, investigations, and publicity that ensue—to temporarily put the fear of God into corporate evildoers and lay bare the symbiotic relationship between companies and their accountants, investment bankers, and lawyers.

Enron (and many others) have been accused of using "aggressive" accounting. But how aggressive is aggressive? Is General Electric, for example, more or less aggressive than IBM, Coca-Cola, St. Paul, or John Hancock? Is AIG conservative, aggressive, or too aggressive? Where, exactly, is the line between "conservative," "aggressive" and illegal? And what do we make of the fact that the accountants who signed off on Enron, Reliance, The Home, Confederation Life, and First Executive are the same firms that audit everyone else?

Are auditors, actuaries, and investment bankers less conservative than they used to be, and have they, increasingly, become part of a system that helps companies manufacture "performance" by tweaking or manipulating numbers?



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November 15, 2001

The Honorable Alexander B. Grannis
Chairman – Insurance Commitee
New York State Assembly
Legislative Office Bldg. - Room 712
Albany, New York 12248

Memorandum of Support
of A.4641A/A.9273

The purpose of this letter is to support legislation that would eliminate the few remaining areas of conflict between New York statutes and the revised NAIC Accounting Practices and Procedures manual, also known as the Codification guidance. I am the leader of the U.S. insurance practice of PricewaterhouseCoopers (PwC), the largest accounting firm in the world. PwC has a 36% market share of insurance company audits in the United States. We audit more than 140 New York domiciled insurance companies, including New York Life, The Guardian, The Equitable, MONY and Phoenix Home. The total admitted assets of our New York domiciled clients aggregate billions of dollars. PricewaterhouseCoopers has supported adoption of the Codification guidance by the NAIC and the states since the beginning of the project in the early 1990s. As the leader of our insurance audit practice, I can assure you that the vast majority of our clients also support Codification.

I also served as Chair of the American Institute of Certified Public Accountants' Insurance Companies Committee from 1997-99. The AICPA is the national professional organization for CPAs in the United States. With over 330,000 members, it is the body that develops standards of practice for CPAs in matters of accounting and auditing. In my role as Chair, I appeared before the NAIC's Executive Committee, the Commissioners' Roundtable and other high level NAIC committees many times to urge adoption of the Codification guidance, which provides a uniform basis of accounting while at the same time preserving states' rights to regulate and monitor solvency. I also testified twice at hearings of the National Conference of Insurance Legislators, who were convinced to support the project. In addition, the AICPA Insurance Companies Committee worked closely with the NAIC's Codification Working Group to ensure the guidance was comprehensive.

Lobbying letter to Assemblyman Grannis

We believe that standards are lower than they once were because, during prosperity, people want to believe—and because it's in so many people's financial interest to believe. Hallmarks of prosperity are optimism and New Era beliefs, not fear and conservatism. During prosperity, people *speculate* and delude themselves that they're *investing*, and accountants sign off on dubious things, perhaps in the belief that prosperity will eventually make false numbers true.

It isn't novel to posit that there's been a decline in standards. Commenting on General Re's $1.27 billion fourth-quarter net underwriting loss, Standard & Poor's wrote, "Since 2000, General Re's *conservative* [emphasis added] reserving methodologies have waned." If a company controlled by Warren Buffett has become less conservative, what does that say about all other companies? And, if Warren Buffett is unable to detect less conservative reserving methodologies in his largest holding, how easy is it for anyone to detect such behavior at other companies?

V. J. Dowling of Dowling & Partners Securities, a boutique that specializes in insurance stocks, has often referred to the late stage of the property-casualty cycle as "the cheating phase": insurance companies underreserve in order to report better earnings. That Dowling, perhaps the world's best insurance analyst, would time and again call insurance companies *cheaters* is striking. Dowling, however, is a fiercely independent maverick, and his firm abstains from investment banking work.

Analysts at major securities firms, on the other hand, are not in the business of being nonconformists. Shouting "sell" during a bull market—or being too critical—could get an analyst fired. There are exceptions. On February 7, Alice Schroeder, a former CPA and Morgan Stanley's "All American" insurance analyst, published a report entitled "Bonfire of the Beancounters." Schroeder wrote that the insurance industry appears vulnerable to "accounting risk." She stated that the "financial engineering" insurance companies employ "is no longer acceptable." On the subject of "reliable information and adequate disclosure," she wrote: "There are few qualities coveted by investors in an insurance stock more than a trustworthy management that can be relied on to report the numbers fairly…Unfortunately, few insurance companies fully measure up to [this ideal]… Ultimately, we believe that *nearly all insurers have, until now, managed earnings* [emphasis added] within the confines of what has been permissible under the accounting rules." As for the rules: "We believe that 'following the rules' meant…applying accounting standards as if they were the tax code. In other words, companies and auditors parsed and hairsplit ever-more-detailed rules as they applied to ever-more-complex transactions. In our view, this lead to a lowest-common-denominator way of thinking…"

The issue of how accountants go about their business brings us back to the question we raised earlier: Should insurance companies' accountants lobby legislators to enact laws that benefit insurance companies? We'll focus on one instance of this behavior. We don't think the accountant's action was unique. In fact, we believe just the opposite: it was business as usual.

On November 15, 2001, Patrick Shouvlin, the partner in charge of PricewaterhouseCoopers' U.S. insurance accounting and business advisory services, wrote a four-page letter to Pete Grannis, chairman of the New York State Assembly's insurance committee. (For more on Grannis and the important role he played in preventing abusive mutual-holding-company legislation from being passed, see the "The Big Fix," *Schiff's Insurance Observer*, February 1998.)

Shouvlin's letter was entitled "Memorandum of Support of A.4641A/A.9273." It began: "The purpose of this letter is to support legislation that would eliminate the few remaining areas of conflict between New York statutes and the revised NAIC Accounting Practices and Procedures manual, also known as the Codification guidance."

Codification, without going into excruciating detail, is something that insurance companies and the NAIC have been working on for years. Although insurance is regulated by the states (and each state has different regulations), the concept of codification is to have a reasonably uniform set of accounting standards for all 50 states. Right now, most states have enacted codification, or are about to. New York, which has historically had more conservative accounting procedures than most states, has not adopted codification.

The problem with codification is that it doesn't necessarily improve accounting practices, it just standardizes them. While there's something to be said for that, a strong argument can be made that it's not in the public interest to lower the bar when it comes to statutory insurance accounting. Right now, intangibles such as goodwill and deferred tax assets are not allowed to be recorded as admitted assets in New York. Codification would change that: with the stroke of the legislative pen, New York life insurance companies' *statutory* surplus would increase by about 10%.

For reasons not entirely clear, codification has become a hot issue in New York. Life insurance companies are pushing unusually hard for it, and that alone should make legislators wary. Last summer, Thomas Workman, president of the Life Insurance Council of New York, a life-insurance-company trade organization, wrote to Assemblyman Grannis saying that codification was a "critical part of the national initiatives to *improve* [emphasis added] the state insurance regulatory system." Codification, he maintained, "will make a major contribution toward establishing a uniform national standard for reporting the financial condition of insurers. This means 'apples to apples' comparisons among insurers will be the norm for regulators, insurers, rating agencies, and consumers."

In fact, rating agencies do not need "codified" numbers to analyze insurance companies. They already perform "apples to apples" analyses that shouldn't be affected by the accounting changes under codification. Consumers, however, might be impressed by the fact that an insurance company, under the new accounting rules, would have about 10% more surplus than it had under the old rules.

Anyway, back to Patrick Shouvlin's four-page letter to Grannis. An edited version appears below. We have added italics for emphasis:

I am the leader of the U.S. insurance practice of PricewaterhouseCoopers (PwC), the largest accounting firm in the world. PwC has a 36% market share of insurance company audits in the United States. *We audit more than 140 New York domiciled insurance companies*. PwC has supported adoption of the Codification guidance by the NAIC and the states since the beginning of the project in the early 1990s. As the leader of our insurance audit practice, *I can assure you that the vast majority of our clients also support Codification*.

I served as Chair of the American Institute of Certified Public Accountants' (AICPA) Insurance Companies Committee from 1997 to 1999. In my role as Chair, I appeared before the NAIC's Executive Committee, the Commissioners' Roundtable, and other high level NAIC committees many times to urge adoption of the Codification guidance, which provides a uniform basis of accounting *while at the same time preserving states' rights to regulate and monitor solvency*. I also testified twice at hearings of the National Conference of Insurance Legislators

The AICPA Insurance Companies Committee worked closely with the NAIC's Codification Working Group to ensure the guidance was comprehensive.

Adoption of all components of Codification by the states is vital because it promotes "the three c's" of financial reporting—comprehensiveness, consistency, and comparability. Full adoption will result in much greater comparability among companies domiciled in New York and insurers domiciled elsewhere. This is valuable to the Insurance Department because it facilitates its ability to monitor the activities of all insurers doing business in New York, not just those domiciled in New York, [and] *will significantly increase the protection of all insurance consumers in New York*.

Critics of Codification note that the guidance *prescribes admission of two specific assets, goodwill and deferred tax assets*. This was done after thorough discussion at all levels of the NAIC. These assets are subject to very specific limitations [that] are much more strict than those found in generally accepted accounting principles.

To my knowledge, New York is the only state that does not allow deferred tax assets as an admitted asset, and only nine states do not allow goodwill as an admitted asset. If the proposed bill is not adopted, New York domiciled insurers could be at a distinct disadvantage in the marketplace. The prohibition of goodwill as an asset significantly penalizes New York companies that desire to grow through the purchase of other companies.

The argument that the critics use to assail Codification is that the admission of these two assets has the potential for degrading the regulation of solvency within New York. However, *it is wrong to assume that statutory accounting reports are the primary tools used by the Department to monitor solvency*.

As part of the NAIC's solvency agenda, the following tools have been put into place:

1) Development of Risk Based Capital requirements;
2) Requirements for actuarial opinions
3) Requirements for annual audits by *independent* certified public accountants
4) Adoption of Financial Regulation and Accreditation Standards
5) Revisions to the Examiners Handbook
6) Creation of a centralized financial analysis at the NAIC
7) Model laws on authorized insurer investments
8) Revisions to the guaranty funds model laws.

The objective of a set of statutory accounting principles is to achieve consistency and comparability among companies from different states.

As insurance, banking, and securities products begin to look more and more like each other, the relative efficiency of one level of regulation as opposed to 50 has become more pronounced. *The NAIC and the states have responded* by developing a uniform accounting system. As the debate over state versus federal regulation of insurance intensifies in Washington, it would seem that an accounting system that results in more uniformity and comparability only *strengthens the claim that the state regulatory framework is alive and well*.

PwC supports full adoption of Codification because we believe that a comprehensive, consistent, and comparable framework of accounting *is in the best interest of the insurance industry as a whole*.

Codification will improve the reporting process from what currently exists today. *Rating agencies and the capital markets will have a consistent and comparable basis of accounting from which to compare companies*. Further, New York companies will be on a level playing field with companies domiciled elsewhere.

We respectfully urge the adoption of A.4641A/A9273.

Let's ponder some of the key points in the letter, some facts, and raise some issues. PricewaterhouseCoopers (PwC) is the largest insurance-industry auditor. It also provides actuarial and consulting services to its auditing clients. The vast majority of PwC's insurance-company clients want codification. (Insurers

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believe that national accounting standards will help them fend off federal regulation. Most insurers don't want federal regulation because they have far more clout—because of political contributions and their local presence—under state regulation. It is easier to "purchase" a state senator than a U.S. senator.) PwC and other accounting firms, through the AICPA, worked closely with the NAIC to develop codification.

While approval of codification in New York could improve comparability, it would do so at the cost of having less conservative statutory accounting. Since statutory accounting "is not intended to be the primary tool for states to measure solvency," how does codification "significantly increase the protection of all insurance consumers in New York"? Also, since codification will tend to increase New York insurers' reported statutory surplus, what are the unanticipated consequences of this?

Finally, should "independent" auditors be lobbying legislators to enact less conservative accounting practices that would benefit their audit clients?

In a vacuum, Shouvlin's letter seems innocuous—accountants aren't forbidden from speaking out on issues, nor should they be. We don't live in a vacuum, however. When a major accounting firm lobbies a legislator to ease accounting regulations for the benefit its clients, it raises the issue of whether the relationships between the supposedly independent auditor and its clients is too cozy

In theory, auditors provide an independent opinion of a company's books. Shareholders, regulators, creditors, and consumers rely upon auditors' opinions, and have every right to expect that the opinions are untainted. Lobbying for legislation that benefits an auditor's insurance-company clients creates, at the very least, the *appearance* of a conflict of interest.

Naturally, we wanted to know what Patrick Shouvlin had to say about his letter. (Before we get to that, we want to disclose *our bias*—that Shouvlin is a man who has shown excellent judgment: he subscribes to *Schiff's* and has been an attendee at our conferences.)

"We were pushing to develop a comprehensive basis all along," Shouvlin told us. "We spent a fair amount of time with the NAIC working on the codification project.

"If you have 50 sets of principles out there, it can't be good for anyone. If you're going to have state regulation, it should be comparable between states. Uniformity is in people's best interest. The codification standards aren't overly conservative or liberal. For New York to be an outlier doesn't make a lot of sense to me. Accountants don't like outliers."

Shouvlin said that he'd written to Grannis at the request of the Life Insurance Council of New York. "I don't feel I was doing this for the insurance industry," he said. "I feel I was doing it from the accounting profession's point of view."

We'll take Shouvlin at his word, but we think that the accounting profession would be wise to reexamine its practices. Who do auditors *really* represent? Their clients, or those who rely upon their opinions—the public?

We think the answer is clear. It's foolhardy to blindly rely on the opinion of an accountant, or, for that matter, a rating agency, investment firm, or any other "expert." Unfortunately, people must use judgment and knowledge to form their own opinions. ■

To be continued. Our next "Enron-o-mania" issue will examine some of the Enronesque techniques used by insurance companies.

Also, we'll take this opportunity to remind you that Abraham Briloff will be one of the featured speakers at our April 9th conference. Briloff, a Distinguished Professor Emeritus at Baruch College, has been a certified public accountant for 59 years. He has been called "the conscience of the accounting industry," and has been a leader in exposing dubious, inconsistent, and incongruous accounting practices. He is the author of three seminal books: "Unaccountable Accounting," "More Debits than Credits," and "The Truth About Corporate Accounting."

Get 'Em While They Last

There are now 1,176 Enron-related items for sale on eBay, down from 1,778 items on January 25.