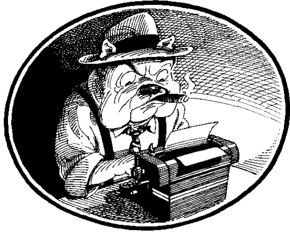

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INSURANCE OBSERVER

The Greatest Risk is Taking Too Much Risk

AIG's Audit-Committee Report

In its reports for the years ending 2001 and 2000, AIG's audit committee disclaims virtually all responsibility for AIG's accounting, internal controls, and financial statements. It also says that it cannot assure that AIG's independent accountants are actually "independent." (The most recent audit-committee report is on page 17 of AIG's proxy statement.)

If AIG's audit committee 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, 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 trade?

Before discussing these issues, we'll note that AIG has been the greatest success story in the insurance business. It's the largest, most important insurance organization in the world. The story of its success, however, is not readily available. Although Hank Greenberg is a legend, his achievements have not received widespread attention. *Jack: Straight from the Gut* is on the best-seller list; *Hank: Straight from 70 Pine Street*, will probably not be written.

We have great admiration for Greenberg (given his record, it's hard not to), and are planning to write a lot about AIG in the coming months. Although we'd prefer to write chronologically, publishing constraints make this difficult. Thus, this article focuses on current issues rather than on AIG's 1969 exchange offers or Greenberg's letters to shareholders in the 1970s, even though all of these subjects are of equal interest to us.

Hank Greenberg stays ahead of his competitors.

In the post-Enron Era, the minutia of accounting principles have become of greater concern to many. Investors, having recently seen several trillion dollars of stock-market value melt like butter on a hot skillet, are more skeptical of companies whose finances are complex or opaque—even those companies with fine long-term records. This wariness is logical; if you can't understand a business and analyze its financials, how can you place a value on the company?

This was not a question asked often enough during the great bull market, when the "extrapolation method" of analysis was sufficient for many "investors." (They would take recent years' *reported* earnings and project the same growth rate for many years into the future.) This method had its advantages: it was really simple and saved a lot of time that would have otherwise been spent reading balance sheets, cash-flow statements, and footnotes.

The extrapolation method has a drawback, however—it doesn't work. The footnotes, fine print, and SEC-mandated disclosures are there because they're important. Words really mean something, and when a company says something unusual—or doesn't say something usual—one should take that into consideration.

AIG has a long record of growth, but the market's opinion of its growth has varied. In 1988, AIG's stock traded at an average of 9.2 times earnings. By December 8, 2000, when the stock hit an

all-time high of $103.75 (it is now $71.51), the p/e ratio had quadrupled to 42. Such a multiple is difficult to justify in any company, much less one so large that its future growth rate cannot possibly match its past.

What is the proper multiple for a highly complex, international financial-services conglomerate whose businesses are cyclical? We don't know—nor does anyone else—but the lower the multiple, the more appealing we find the stock.

In 2001, AIG's earnings did something that not one of the dozens of analysts following the company expected—they declined. The decline, the first since 1984, was a reminder that even the greatest companies are not immune to the vicissitudes of business. Investors, however, don't like being reminded that the earnings of "growth" companies do not always grow. (While a growth company's failure to grow may be irksome to growth-stock investors, it is not nearly so irksome as the failure of a growth company to maintain solvency—the condition that afflicted Enron.)

According to the SEC, "Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process." Financial statements are *prepared* by management and *audited* by independent accountants.

PricewaterhouseCoopers, AIG's independent accountants, says that it conducted its audit of AIG in accordance with generally accepted standards, and that the audit provides a reasonable basis for its opinion that AIG's financial statements present the company's financial condition fairly, in all material respects. This is standard lingo found in virtually every financial statement.

AIG's audit-committee report, however, provides an opinion that's ambiguous, elusive, equivocal, hedged, and oblique—qualities that aren't particularly comforting to investors or creditors. (Perhaps the only outside parties that would like the wording in the audit-committee report are the company's D&O insurers.) The report does not contain the same language found in many other audit-committee reports. In fact, AIG's audit committee's disclaimers are so extensive that they render the report virtually meaningless.

The key paragraph in AIG's audit-committee report follows. We've added italics 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."*

The disclaimers in AIG's audit-committee report aren't common. Perhaps AIG is on the cutting edge, however, and in years to come more audit committees will adopt similar verbiage.

Viewed by itself, AIG's audit-committee report is not such a big deal. But viewed in the context of AIG's inherent complexity and the inherent imprecision of insurance-company "earnings," it takes on greater meaning and is worth thinking about.

AIG' stock has declined more than 30% from its all-time high, and is now trading at the price it was three years ago—despite the fact that the company is expected to produce record earnings this year. On many occasions, AIG has benefited from having a high p/e ratio; it has been able to use its stock to make acquisitions on attractive terms. Its current p/e ratio (about 20 times projected earnings) reduces the possibility of most stock acquisitions because the effect of issuing stock at this level (relative to what AIG would receive in return) would probably be dilutive to earnings rather than accretive.

None of this is lost on Hank Greenberg, who seemingly knows everything. He is acutely aware of the importance of financial strength as well as the importance of perception. If, for example, people perceive—correctly or incorrectly—that AIG does not pay claims, it will, at the margin, hurt AIG's business. If AIG's financial strength is perceived as being weaker than it is, that can become a self-fulfilling prophecy as lenders demand slightly higher spreads, causing the company's cost of capital to rise, thereby reducing profitability. Finally, if AIG's stock price is tainted by Enronesque issues such as complexity, lack of transparency, or sheer incomprehensibility, then it stands to reason that the stock will trade at a lower multiple of earnings than it would otherwise.

While no one knows with certainty the reasons why a stock goes down (other than the obvious—that sellers were more persistent than buyers), it appears that

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AIG's stock has been under pressure for several reasons: 1) it had been selling at an unusually high multiple; 2) the company reported a decline in earnings last year, 3) investors are more concerned about accounting and complexity than they have been in the past; 4) AIG is difficult to understand, and investors are less willing to accord high multiples to things they don't understand; and 5) AIG is a diversified financial company rather than a pure play on property-casualty, and therefore is not benefiting as much as some companies from the turn in cycle.

AIG's stock price appears to be of considerable concern to AIG, and the company has been attempting to respond to various criticisms. For example, it has been faulted for having too few "independent" directors. Its response: Bernard Aidinoff, a director since 1984, is now "senior counsel" at Sullivan & Cromwell (which represents AIG) rather than a "partner." And Carla Hills, a director since 1993, terminated her consulting agreement with AIG in early 2002. We doubt that these cosmetic changes will make Aidinoff and Hills better or worse directors than they were before. (Most corporate directors aren't *too* independent, anyway. If they were, they wouldn't be put on a board in the first place.)

AIG has now instituted quarterly conference calls—the first was held last week—and has provided additional disclosure in its annual report and 10-K. It has also attempted to deal with the "succession" issue by creating an Office of the Chairman, naming co-chief operating officers, and announcing several promotions. (The actuaries at *Schiff's* think that Greenberg is in better shape than most insurance-company CEOs, and won't need a successor for many years.)

It's impossible to say whether any of the changes made by AIG will have any effect on the company's stock price. As Benjamin Graham famously wrote, in the short term the market is a voting machine; in the long term it is a weighing machine.

Which brings us to the morning of April 22. AIG's stock was down several points amidst rumors that the company would miss its second-quarter earnings (it didn't), and that it was being investigated. In the early afternoon, AIG put out the following press release: "AIG's stock is trading down significantly. We have observed considerable short selling in the stock and have requested the New York Stock Exchange and the Securities and Exchange Commission to investigate this activity."

Blaming shortsellers for a decline in a company's stock is a tactic often used by highly promotional companies whose shares are overvalued, and is unusual for a company of AIG's stature, for many reasons. First of all, *shortselling is not illegal or unethical*. (At year end, AIG was short $8.3 billion of securities and commodities.) So why did AIG ask the authorities to investigate? ("No comment," said AIG.)

If AIG is so concerned about the trading activity in its stock, why didn't it ask the SEC and NYSE to investigate the

considerable *buying* (and all the brokerage "buy" recommendations) when its shares were 50% higher and, apparently, trading under the influence of irrational exuberance?

Also, *how* did AIG "observe" short selling on April 22? ("No comment," said AIG.)

AIG's request that the NYSE investigate carries extra weight. Hank Greenberg is on the NYSE's board, and AIG director, Frank Zarb, is the former chairman of the NYSE's nominating committee. Section 202.03 of the NYSE's "Listed Company Manual" provides the following recommendations for dealing with rumors or unusual market activity:

202.03 Dealing with Rumors or Unusual Market Activity

If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. *If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect*…[Emphasis added.]

The Exchange recommends that its listed companies contact their Exchange representative if they become aware of rumors circulating about their company...Information provided concerning rumors will be promptly investigated.

Why didn't AIG use the standard NYSE comment—that it knows of no corporate developments to account for the unusual market activity—in its press release? ("No comment," said AIG.)

After all the "no comments" we didn't bother asking AIG if it "observed" any of the alleged shortsellers reading a copy of the company's audit-committee report. ■

Coming soon in a future issue of Schiff's Insurance Observer*: "The Great Greenberg and the Rise of AIG."*