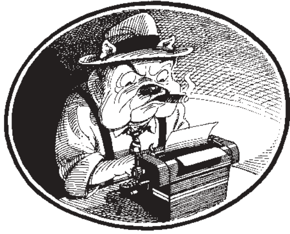

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INSURANCE OBSERVER

AIG: The Art of Manipulation?

Deceptive Earnings Releases

On Wednesday, February 11, American International Group, whose advertising slogan is "We Know Money," issued a press release containing its fourth-quarter and full-year earnings and related financial information. It was a swell press release—except for the fact that it was misleading, deceptive, and inconsistent with the way AIG had highlighted its earnings in previous press releases.

If AIG's intention was to dupe the press and the public, it appears to have succeeded. News organizations across the globe reported the figure AIG highlighted—68% growth in earnings—whereas, based on its previous releases, 14.7% growth would have been a more appropriate figure. (The media typically report companies' earnings by reprinting or summarizing press releases.)

This was not the first time that AIG presented its earnings in a deceptive way. *Schiff's* recently conducted a study of the company's quarterly-earnings releases and annual reports during the 1998-to-2003 period and determined that from the fourth quarter of 1999 through the fourth quarter of 2003, AIG used four definitions of earnings, switching back and forth among those definitions ten times. These switches improved the appearance of AIG's growth rate and made declines in earnings seem like increases. [See the chart on pages 5 and 6.]

Since the fourth quarter of 1999, AIG has issued 16 earnings releases and four annual reports. In 19 of these releases and reports, AIG highlighted the better numbers that were created by switches in the ways it defined its earnings. Perhaps it's chance, but these switches never made AIG's earnings or growth rate appear lower (even though they were lower in many cases). The figures that AIG highlighted gave a misleading impression in ten earnings releases and annual reports.

It is appropriate, when a company presents its financial results, for it to do so in a consistent manner: results from one reporting period should be comparable with those of the previous year (as they say, apples should be compared to apples). If a company constantly changes its method of reporting, then it may be difficult—or impossible—to track its progress, or lack thereof.

AIG's shares trade on the New York Stock Exchange. The NYSE's "Listed Company Manual" states that, "Unfavorable news should be reported as promptly and candidly as favorable news." It continues: "Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar impact."

We don't know if AIG *deliberately* disguised unfavorable news (i.e. masking lower earnings and a lower growth rate); but AIG's earnings releases and annual reports have, in fact, disguised unfavorable news. We can't help but note a remarkable coincidence: that the numerous switches AIG made in its earnings presentations improved the earnings or growth rate that AIG highlighted 95% of the time. What are the odds that AIG—by sheer chance—switched its standards ten times in four years, and that these switches—by sheer chance—improved the appearance of AIG's earnings or growth rate 19 out of 20 times? (The odds that a coin flip will turn up heads 19 out of 20 times are about 50,000-to-1.)

At one time AIG's quarterly earnings' releases and annual reports highlighted the company's "net income" according to Generally Accepted Accounting Principles (GAAP). Net income is a company's actual "bottom line," but it isn't always the best way of looking at an insurance company's results. Analysts often make adjustments to the bottom line in order to get a clearer picture of actual performance. It is common to exclude the effect of realized capital gains and losses on earnings. The reason for this is that the timing of gains and losses is generally discretionary, and realized gains and losses usually bear no relationship to a company's investment results in a given quarter or year. A company might have realized losses in a year in which its investment portfolio appreciated, and it might have realized gains in a year in which its portfolio declined. Since *unrealized* gains and losses aren't run through the income statement (they're a balance-sheet entry), it can be fair and useful to present "pro-forma" earnings excluding realized gains and losses—even though this doesn't conform to GAAP.

From 1992 through 1999, AIG had realized capital gains in 30 quarters and

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small realized capital losses in two quarters. (The losses were 1.03% and 0.47% of pretax income, in the fourth quarters of 1998 and 1999, respectively.)

In 1998 and 1999, AIG's earnings releases highlighted the company's "net income" but also provided a pro-forma figure—"income, as adjusted"—which excluded realized capital gains or losses.

In the first quarter of 2000, AIG changed the way it *highlighted* its growth rate in its press releases; it began excluding realized capital losses. (In every quarter since then AIG has had realized capital losses. These losses have often been sizable—greater than 10% of pretax income.) "AIG's First Quarter 2000 Income Excluding Realized Capital Gains (Losses) Rose 15.5%," stated the headline of the company's press release. If AIG had used its previous practice of highlighting "net income," the headline would have declared that income increased by 12.3%.

There's a big difference between a 15.5% growth rate and a 12.3% rate. Over 20 years, $100 compounded at a 15.5% rate will grow to $1,785, versus $1,018 for the same sum compounded at a 12.3% rate. All things being equal, companies with higher growth rates (or the appearance of such) invariably trade at much higher P/E ratios than those with somewhat lower growth rates. For decades, AIG has been viewed as a "growth" company, and its stock has usually traded at a much higher P/E ratio and price-to-book ratio than have the stocks of most other insurance and financial-services companies. (Often, the higher P/E ratio was justified.)

AIG's practice of highlighting the pro-forma growth in earnings by excluding realized gains and losses isn't troubling *per se*. In AIG's 2000 annual report, chairman and CEO Hank Greenberg noted that "we [AIG] and the investment community look at our results" this way. What is troubling, however, is that AIG did not subsequently highlight its earnings this way when doing so resulted in a lower rate of growth.

AIG continued to highlight the pro-forma "income, as adjusted" growth rate through the second quarter of 2001. The World Trade Center loss occurred the following quarter. AIG then highlighted its results using a pro-forma method it called "core earnings," which excluded underwriting losses related to the World Trade Center attack. In the next four quarters AIG made at least three more switches in the method it used to come up with figures that it highlighted. First it used income excluding capital losses; then it used net income. Finally, when it took a $1.8 billion loss-reserve charge in the fourth quarter of 2002, it used a new variation of pro-forma "core earnings" that *excluded* the loss-reserve charge.

In his letter to shareholders in the 2002 annual report, Greenberg dragged a red herring across the issue of the loss-reserve charge, calling it "an extraordinary reserve adjustment." He wrote that "no actuarial calculation could have predicted the ex-

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9:00 a.m. **David Schiff** editor of ***Schiff's Insurance Observer***, will start off with a look at the seamy side of the insurance business. Throughout the day he will, as always, interrogate the speakers and force them to answer brazen questions.

9:30 a.m. Over the decades, **William R. Berkley**, CEO of ***W.R. Berkley Corporation***, has demonstrated that he knows how to build value in hard markets and in soft markets. When Bill spoke at our 1999 conference, he was acutely aware of the risks—and opportunities—that lay ahead. Since then, his business has been on a roll and his company's stock (which we had recommended) has more than quadrupled. Bill will give us his atypical perspective in his typically eloquent manner.

10:40 a.m. **Betsy McCaughey** is a thinker, author, and expert on health policy. Her 1994 critique of the Clinton health plan, "No Exit," caused a ruckus and helped kill the plan. Betsy, who was an unusually independent Lieutenant Governor of New York, has published two books on U.S. constitutional history and is writing a book on health care. She will tell all, including how "medical courts will solve the malpractice crisis."

11:20 a.m. ***Milberg Weiss Bershad Hynes & Lerach LLP*** didn't invent the class-action lawsuit, but, as the largest contingency-fee-based law firm representing plaintiffs, it has certainly perfected it. Senior partner **Melvyn Weiss** is a leading practitioner in the fields of securities, insurance, environmental, antitrust, and consumer litigation. Mel's comments may leave some members of the insurance industry feeling afraid—very afraid.

Noon Lunch: Decent food; fine conversation.

1:00 p.m. Many insurance companies don't have the data to price risk properly. **Daniel Finnegan**, president of ***Quality Planning Corporation***, is a statistician who knows how to compile, analyze, and use data in ways that can create a significant underwriting edge. "There's enormous room for the improvement of prediction," he notes matter-of-factly. Daniel will take us into the world of rating error, black boxes, credit scoring, database analysis, geo-positioning systems, privacy issues, and probabilities. And that's just the beginning. *continued on next page*

‘Grand Delusion’

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1:45 p.m. It may surprise some to learn that *Schiff’s* has a hero. His name is **Joseph Belth** and he is, of course, the editor of ***The Insurance Forum***. Joe, whose articles, speeches, and testimony have shaken up the life-insurance industry, is the author of numerous books and journal articles and professor emeritus of insurance at the Kelley School of Business at Indiana University. He’ll tell you what’s bothering him these days.

2:45 p.m. **Jay Brown** is CEO of triple-A-rated ***MBIA Inc.***, which specializes in credit-enhancement insurance. He was previously CEO of Talegen Holdings, and before that, CEO of Fireman’s Fund. Jay, who’s an actuary, has a contrarian nature and a keen appreciation of risk—desirable attributes for one running a company with $6 billion of equity and $500 billion of financial guarantees outstanding. He will offer his thoughts about insurance, credit, financial guarantees, risk versus reward, and more.

3:45 p.m. **David Schiff** will discuss where he sees value and solvency (or the lack thereof), and have his say on the great insurance issues of the day.

4:45 p.m. Attendees will socialize with their fellow insurance mavens and observers, discussing the day’s events and making deals over **cocktails** while taking in the view from the top of the New York Athletic Club.

6:00 p.m. There will be an **additional reception and dinner** for those who want more of a good thing. The venue is the Coffee House, a convivial and somewhat worn-at-the-edges private club devoted to “agreeable, civilized conversation.” Attendance is limited to 36 people.

plosion of litigation in the United States, which has resulted in an enormous increase in the frequency and severity of liability claims and judgments.”

The $1.8 billion charge, however, wasn’t for events that occurred 25 years earlier; it was for losses during the 1997 to 2001 accident years. The only thing that made the charge “extraordinary” was that AIG doesn’t usually make such large mistakes. The reserve charge was not attributable to an isolated legal judgment or to discontinued operations; it was for excess casualty (including excess workers’ comp), directors and officers liability, and “other casualty” (including healthcare liability).

AIG’s actuaries may not have picked up on Greenberg’s so-called “explosion of litigation,” but Greenberg did. He’s criticized “tort law” and the “legal system” for decades. He has written that “courts in our country continue to broaden the standards of legal responsibility and increase the size of awards,” and raised the “persistent matter of excessive liability awards by courts.” (The quotations just cited are from Greenberg’s 1977 letter to shareholders, AIG’s 1985 annual meeting, Greenberg’s 1986 letter to shareholders, and his 1989 letter to shareholders, respectively.) According to Tillinghast-Towers Perrin’s “U.S. Tort Costs: 2003 Update,” inflation-adjusted tort costs per citizen grew from $716 in 1990 to $809 in 2002.

AIG’s $1.8 billion reserve charge was the result of underwriting mistakes over five years. Was it really appropriate to treat these mistakes as “extraordinary” items that deserved to be factored out of highlighted earnings in 2002? If it *was* appropriate, then wouldn’t it have also been appropriate for AIG’s fourth-quarter 2003 earnings release to compare 2003’s earnings with the pro-forma earnings AIG highlighted in 2002? (If AIG had done that, it would have reported a 14.7% increase in earnings rather than a 68% increase.)

Page one of AIG’s 2002 annual report contains a bar chart of the company’s net income each year from 1998 to 2002. The figure for 2002 adds back the $1.8 billion loss-reserve charge, making the company’s growth have a smooth upwards trajectory. Although AIG’s chart didn’t include the charge in 2002, the charge should go somewhere. If it was appropriate to add back $1.8 billion to 2002 earnings, then $1.8 billion should have been subtracted from the 1997-to-2001 years as an acknowledgment that earnings had been *overstated* during that period.

Inconsistent Reporting

During 2003, AIG continued to switch the way it highlighted its earnings and growth. In the first quarter it highlighted “income, as adjusted” (excluding capital losses). For the next three quarters it switched to “net income”—despite the fact that Greenberg had written that the “income, as adjusted” method was the way AIG looked at its results.

We’ve noticed one constant in the way AIG has highlighted its earnings or growth: 19 out of 20 times the company used the figures that made its results look better.

On February 18, we discussed our observations with AIG and asked why the company changed its methodology so often, noting that the changes improved AIG’s figures 85% of the time. (We subsequently determined that they improved them 95% of the time.)

Two days later AIG provided a polite response: “AIG gives a thorough accounting in its quarterly earnings news releases, and it reports its results in compliance with all SEC and accounting regulations.” Because this was such a brief response, we’ll add the following: AIG is the world’s leading international insurance and financial-services organization, with operations in approximately 130 countries and jurisdictions. Its earnings releases include GAAP financial information.

On December 4, 2001, the SEC issued a release containing cautionary advice regarding the use of pro-forma financial information in earnings releases:

continued

...It is appropriate to sound a warning to public companies...who present...their earnings and results of operations on the basis of methodologies other than Generally Accepted Accounting Principles ("GAAP"). This presentation in an earnings release is often referred to as "pro forma" financial information. In this context, that term has no defined meaning and no uniform characteristics...

...Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations...

Because "pro forma" information is...derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information...

Companies must pay attention to the materiality of the information that is omitted from a "pro forma" presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information.

In 2003, the SEC issued the final rules for Regulation G, which deals with the use of non-GAAP financial measures. AIG's 2003 fourth-quarter earnings release contains a "comment" on Regulation G. The company acknowledges that its press release contains non-GAAP financial measures, and that a "reconciliation of such measures to the most comparable GAAP figures" is included in accordance with Regulation G. AIG says its press release "presents its operations in the way it believes will be most meaningful and useful, as well as most transparent, to the investing public and others who use AIG's financial information in evaluating the performance of AIG."

If, in the past, AIG also presented its operations in the manner it believed was most meaningful, useful, and transparent, that raises questions, including the following: Why did AIG find it meaningful and transparent to make so many switches in the way it highlighted its earnings and growth rate? Why did AIG highlight "net income" in the third quarter of 1999, "income, as adjusted" excluding capital losses in the third quarter of 2000, "core earnings" excluding certain underwriting losses in the third quarter of 2001, and "net income" in the third quarters of 2002 and 2003? Is it a coincidence that these switches made AIG's results or growth rate appear better than they otherwise would have been in 19 of 20 instances?

AIG's "comment on Regulation G" notes that "the determination to realize capital gains or losses is independent of the insurance underwriting process... Realized capital gains or losses for any particular period are not indicative of quarterly business performance." It goes on to say that "providing only a GAAP presentation of net income and operating income makes it much more difficult for users of AIG's financial information to evaluate AIG's success or failure in its basic business, that of insurance underwriting, and may, in AIG's opinion, lead to incorrect or misleading assumptions and conclusions. The equity analysts who follow AIG exclude the realized capital gains and losses in their analyses for the same reason..."

In other words, AIG seems to be saying that if it "only" provides GAAP net income figures that might be misleading because "*income, as adjusted*" *to exclude realized gains and losses* is the more important measure of performance.

If it might be misleading to provide only GAAP figures, then isn't it misleading (and downright sneaky) to *highlight* the growth rates for GAAP "net income" when, in fact, the growth rates for "income, as adjusted" (excluding capital gains and losses) are considerably lower?

With that in mind, let's examine AIG's July 24, 2003 earnings release. The headline reads, "AIG Reports Second Quarter 2003 Net Income Rose 26.4% to $2.28 Billion." To report 26.4% growth seems spectacular. But why would AIG highlight "net income" instead of the figure it has said is more meaningful: *"income, as adjusted" (excluding gains and losses)*? Did the fact that "income, as adjusted" grew 13.9%—about half as much as "net income"—have anything to do with AIG's decision to highlight the higher, misleading figure? Ask Hank Greenberg. And while you're at it, ask him why AIG's 2003 third-quarter headline declared that "Net Income Rose 26.9%," when, in fact, "income, as adjusted" rose 15.4%?

It would have been nice if AIG explained how it came to pass that in 19 out of 20 instances it highlighted the earnings or growth rate that was most favorable. The company could have told us it was chance. It could have explained why highlighting "net income" some of the time and highlighting ever-changing pro-forma figures other times really was the best way to present its performance in a fair, honest manner. It could have said that it was "trying to put a positive spin on its results," then tried to provide some reason why that was not deceptive.

AIG has long been respected and valued for the steadiness with which its earnings have grown. Beginning in 2000, AIG's earnings releases and annual reports have given the impression of greater growth and consistency than that which actually occurred. AIG is a gigantic company and Hank Greenberg is a brilliant man. But people should be wary of companies that don't present their results fairly. AIG's manner of highlighting the most favorable figures and growth rates raises a sad question: Should AIG be trusted?

Please refer to the charts on the following pages.

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AIG: The Art of Manipulation? Deceptive Earnings Releases and Annual Reports

From the fourth quarter of 1999 through the fourth quarter of 2003, AIG used four definitions of earnings, switching back and forth among those definitions ten times. These switches improved the appearance of AIG's growth rate and made declines in earnings seem like increases.

During this period, AIG issued 16 earnings releases and four annual reports. In 19 of the 20 releases and reports, AIG highlighted the better numbers that were created by switches in the ways it defined its earnings. The highlighted figures were misleading ten times.

The table below tracks AIG's quarterly releases and annual reports. The first column describes which figures AIG highlighted in its release or annual report. Note where AIG switched the way it highlighted its earnings (i.e. net income, income as adjusted, core earnings, etc.). The second column notes the effect the switches had on the earnings that AIG's highlighted. The third column notes the result of the switches (i.e. inconsistent, misleading, etc.). The last column contains our comments.

	What Figure is Highlighted?	Effect	Result	Comments
1999 - 1Q	Net Income	Neutral		
1999 - 2Q	“ “	Neutral		
1999 - 3Q	“ “	Neutral		
1999 - 4Q	“ “	Neutral		
Annual Report	“ “	Neutral		
2000 - 1Q	Income, as adjusted (excludes Capital Realized Losses)	Improve	Inconsistent	Reports 15.5% growth in “adjusted” income instead of 12.3% growth in net income
2000 - 2Q	“ “ “	Improve	Inconsistent	Reports 13.1% growth in “adjusted” income instead of 10.2% growth in net income
2000 - 3Q	“ “ “	Improve	Inconsistent	Reports 14.6% growth in “adjusted” income instead of 9.3% growth in net income
2000 - 4Q	“ “ “	Improve	Inconsistent	Reports 14.8% growth in “adjusted” income instead of 11.5% growth in net income
Annual Report	1) Net Income; 2) Net Income, as adjusted (excludes Realized Capital Losses)	Improve	Inconsistent	Hank Greenberg mentions adjusted income in letter to shareholders. (Says it’s “the way we and the investment community look at our results.”) Reports 14.8% growth in adjusted” income instead of 11.5% growth in net income
2001 - 1Q	Income, as adjusted (excludes Realized Capital Losses)	Improve		Reports 15.2% growth in “adjusted” income instead of 13.8% growth in net income
2001 - 2Q	“ “ “	Improve		Reports 15.8% growth in “adjusted” income instead of 15.6% growth in net income
2001 - 3Q	Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges)	Improve	Misleading	9/11 WTC loss. American General restructuring charges. AIG now reports “core income” instead of “adjusted” income. (“Core income” is reported ahead of “net income.”) Headline of AIG’s release: “Core income rose 14.1% to $1.92 million.” This is an unfair comparison and inconsistent with prior reporting. An accurate headline would have been, “Adjusted income declines 18.5%.”
2001 - 4Q	1) Net Income; 2) Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges)	Improve	Misleading	Headline cites “net income.” Text shows “core income” increased 13% in 2001. Core income increased 5% when 9/11 WTC loss is counted.
Annual Report	1) Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges); 2) Net Income	Improve	Misleading	Does not show “adjusted” income, which is lower than “core income.” On page 1, a five-year graph of “Net Income” uses “core income” for 2001. Since high-severity, low-frequency losses like 9/11 WTC do occur, treating them as extraordinary or non-recurring—which AIG has done—smoothes core earnings. In a table showing an 11-year summary of consolidated operations, the bottom line—net income—omits the charge for the WTC losses. In his letter to shareholders, Hank Greenberg writes about “Reaffirming our Corporate Values,” and says, “Every year we work hard to improve our disclosure...We will always...adher[e] to the highest ethical standards, and provid[e] a thorough and accurate picture of our operations and financial performance.” Annual report shows so-called core income increasing by 13%. It only increased 5% when all underwriting losses are included.

(table continues on next page)

AIG: The Art of Manipulation? *(continued)*

	What Figure is Highlighted?	Effect	Result	Comments
2002 - 1Q	Income, as adjusted (excludes Realized Capital Losses)	Improve		AIG's earnings are released three days after AIG, whose stock is under pressure, issues press release claiming to "have observed considerable short selling in [AIG's] stock." AIG requests that the NYSE and SEC "investigate this activity."
2002 - 2Q	Net Income	Improve	Misleading	AIG's earnings are released one day after AIG's stock hits its year's low of $46.71 (down from an all-time high of $103.75 on December 8, 2000). Investors are skeptical of complex "black-box" financial companies like AIG, and are worried whether AIG can continue to achieve the steady growth it is known for. By reporting "net income" instead of "adjusted" income, AIG shows a 37% increase in earnings instead of a 9.8% increase.
2002 - 3Q	" "	Improve	Misleading	In the prior year's third quarter, AIG used "core income," which excluded the WTC losses and various restructuring charges. In the second quarter of 2002, however, AIG begins highlighting "net income." Because the third quarter of 2001 had been bad, AIG can expect to show sensational growth for the year by highlighting "net income." AIG reports that "net income" increased 60.8% during the first nine months of 2002. Core income—which AIG used in the previous year's third quarter—increased 11.3%.
2002 - 4Q	1) Net income; 2) Income,as adjusted (excludes Realized Capital Losses and a $1.8 billion *Loss-Reserve Charge*)	Improve	Misleading	AIG announces a $1.8 billion loss-reserve charge. In the previous seven quarters AIG had gone from reporting "adjusted" income to "core income" to "net income" to "adjusted" income then back to "net income." By highlighting "net income" for 2002, AIG once again portrayed its earnings in a misleading way. In 2001, Greenberg told shareholders that income adjusted to exclude realized capital gains and losses was the best way to view AIG's results. In 2002, AIG reports that "net income" increased 2.9% and "income as adjusted" (*excluding the reserve charge*) increased 11.9%. If AIG had reported "adjusted" income (excluding capital gains and losses) it would have shown a 4.2% decline for the year.
Annual Report	1) Income, as adjusted (excludes Realized Capital Losses and a $1.8 billion *Loss-Reserve Charge*); 2) Net Income	Improve	Misleading	On page 1, a five-year bar chart of "Net Income" uses "core income" for 2001 and 2002. (Core income was a much higher figure.) Commenting on the $1.8 billion charge to increase loss reserves, Greenberg, who has been complaining about the legal system for more than 30 years, blames society: "No actuarial calculation could have predicted the explosion of litigation in the United States." The truth: AIG underestimated its losses during 1997-2001.
2003 - 1Q	1) Income, as adjusted (excludes Realized Capital Losses)	Neutral		First time in three years that AIG doesn't highlight earnings in the most favorable way. "Income, as adjusted" (excluding realized capital gains and losses) is an apples-to-apples method of looking at the change in earnings from year to year.
2003 - 2Q	Net Income	Improve	Misleading	Misleading reporting resumes. Headline says "net income rose 26.4%." In fact, "adjusted" income rose 13.9%.
2003 - 3Q	1) Net Income; 2) Income, as adjusted (excludes Realized Capital Losses)	Improve	Misleading	Highlights earnings both ways, but first states that "net income rose 26.9%." Misleading because "adjusted" income, which Greenberg has said is the way AIG and the investment community look at the numbers, rose 15.4%.
2003 - 4Q	" " "	Improve	Misleading	AIG's headline says "net income" increased 68%. AIG doesn't provide an "income, as adjusted" figure (excluding the loss-reserve charge) like it did the previous year. Had it done so, one would have seen that, on an apples-to-apples basis, earnings increased 14.7%—far less than the 68% figure AIG trumpeted. Since AIG had highlighted the "adjusted" income figure in the previous year's release and in its annual report, it should have included comparable figures here.