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MARKET PLACE

A.I.G. Disclosures Give a Hint of How Accounting Inflated Results

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Maurice R. Greenberg, former chief executive of [American International Group](#), was a guru to many. To investors and employees, he was the genius who presided over a company that produced consistent growth in a volatile business. Within the insurance industry, Mr. Greenberg was an icon for generating fewer losses than peer companies on the insurance A.I.G. wrote.

Now that performance appears to have been a mirage. In A.I.G.'s most recent inventory of accounting improprieties, disclosed late Sunday, the company said it would probably reduce its net worth by \$2.7 billion, \$1 billion more than it had previously estimated.

Mr. Greenberg, ousted as chief executive and chairman in March, now resembles the man behind the curtain, working furiously with a handful of colleagues at the top to maintain an awesome image to the investing world that was not quite reality.

A.I.G. has made two disclosures about its accounting errors in recent weeks, one on March 30 and another on Sunday. Both are the result of an internal investigation into the company's practices and have focused on how the missteps will reduce its net worth or balance sheet.

What may be more interesting to investors, however, is the way the improprieties artificially inflated the company's operating income. Since the company will no longer employ such tactics in the future, the accounting disclosures may provide a clue to how different A.I.G.'s operating results might be in coming years.

Using the details the company provided, it appears that almost 90 percent of the \$2.7 billion restatement of A.I.G.'s net worth - \$2.4 billion - consisted of items that would have been reflected on its income statement, which shows profits or losses for each operating segment for the year. That figure is about 3.8 percent of its total operating income from 2000 to 2005.

Chris Winans, an A.I.G. spokesman, said the company would not comment on the effects that the accounting errors might have on its income statement. Only when the company publishes its long-awaited annual report for 2004, he said, will it become clear how the income statement will look after the improprieties are incorporated in it.

Mr. Winans did confirm, however, that the \$2.7 billion in accounting errors acknowledged by the company going back to 2000 is an after-tax figure. On a pretax basis - A.I.G.'s tax rate is roughly 30 percent - that number will grow considerably.

For the moment, investors seem relieved that the accounting tricks amount to only 3 percent of the company's net worth. Yesterday, they bid A.I.G.'s stock up \$2.59, or 5 percent, in heavy trading. Its shares closed yesterday at \$53.44.

Yesterday, analysts at Fitch Ratings, a credit rating concern in Chicago, and at Moody's Investors Service in New York downgraded A.I.G.'s credit quality a notch. Fitch said that "the uncertainty surrounding A.I.G.'s financial condition and future financial performance has grown to levels beyond the expectations embedded in Fitch's previous rating levels." Fitch also said that the outlook for A.I.G.'s credit rating was negative.

Sentiment at the rating agencies seemed to extend beyond the impact of the latest disclosure to the company's ability to generate the kind of stellar results that have defined it as an industry leader in recent years.

"With all that's happened, they won't quite have the stature they have had," said Julie Burke, a managing director in the insurance group at Fitch Ratings. "They had a unique advantage with reinsurance purchasing, pricing and risk selection. Going forward, insurers and reinsurers will put increased pressure on A.I.G. and it will be harder for them to have those advantages."

A.I.G. said Sunday that the errors in its accounting "appear to have had the purpose of achieving an accounting result that would enhance measures important to the financial community and that may have involved documentation that did not accurately reflect the nature of the arrangements."

One new area of concern in A.I.G.'s most recent disclosure is so-called top-level adjustments, which involve \$100 million of accounting entries made by top management to increase reported earnings. "A.I.G. has determined that certain entries appear to have been made at the direction of certain former members of senior management without appropriate support," the company noted Sunday in its news release.

People briefed on the investigation said that two of the managers involved in much of the questionable accounting were Mr. Greenberg and Howard I. Smith, the former chief financial officer who was fired in March for refusing to cooperate in the investigation. Andrew M. Lawler, Mr. Smith's lawyer, did not return calls for comment. David Boies, one of many lawyers representing Mr. Greenberg, criticized the

report's conclusion, and also that his client did not have a chance to participate in it.

Trying to understand how A.I.G.'s results were manipulated and how the company will perform in the future without such maneuvers is, at best, a guess. But the effects of the tricks on the company's operating income back to 2000 can be approximated by examining the areas highlighted by the company's recent disclosures and seeing which of them may have enhanced operating income at A.I.G.

The company has not disclosed figures relating to all of the accounting improprieties and it has not concluded that it has identified all the problems. But armed with the figures A.I.G. has supplied, it appears that roughly \$2.4 billion of the accounting errors consisted of items that would have to appear on A.I.G.'s income statement. Computing that as a pretax figure puts the number at around \$3.4 billion.

That number may be high because some of the problems relate to A.I.G.'s investment income, which may have involved tax-free municipal bonds and other instruments with favorable tax treatment. And the company has said that the reversal of improper hedging may add \$2.4 billion to its income, although changing its hedging practices will bring considerable volatility to its earnings, A.I.G. said.

In any case, the overall adjustments announced by A.I.G. seem to show a company concerned about its operating income over the past five years. This is not surprising: financial analysts and investors care deeply about operating income because it is seen as the cleanest representation of how a business is performing.

"Both the proposed decrease in shareholders' equity of \$2.7 billion and the proposed increase in shareholders' equity of \$2.4 billion represent decisions to change what A.I.G.'s officers, directors and auditors at the time concluded were appropriate accounting decisions," said Mr. Boies. "Those decisions were made not merely by former senior management, but by present senior management, including operational heads, and the company's present directors and auditors as well."

As A.I.G. has acknowledged, the biggest single problematic area in the company's books is the reinsurance deals it struck with the Union Excess Reinsurance Company, a Barbados company that had been seen as independent of A.I.G. but is now viewed as a unit whose business will be consolidated onto A.I.G.'s books. As a result, the premiums recorded by A.I.G. on these deals must now be accounted for as deposits, reducing revenues by \$1.2 billion.

The \$300 million that A.I.G. said it did not include in its allowance for doubtful accounts in its domestic brokerage group is also an income statement issue, according to an insurance analyst. So is the \$300 million that A.I.G. said it recorded in net investment income when it improperly sold call options on bonds in which the company had unrealized gains. That \$300 million was generated by premiums A.I.G. received from the buyers of the call options.

A.I.G.'s admission that it temporarily redeemed certain investments in hedge funds to generate investment income - only to buy them back again after a financial reporting period ended - also

manipulated its income. But the company provided no numbers to help quantify the effect, so it is unclear how the income statement will be affected by it.

Another hit to operating income may result from A.I.G.'s improper transformation of underwriting losses into capital losses. These \$200 million in losses relate to the auto warranty business conducted with the Capco Reinsurance Company Ltd., a Barbados reinsurer. An additional \$200 million in deferred acquisition costs - such as commissions promised to sellers of life insurance - that the company did not account for correctly will almost certainly reduce its operating income.

A.I.G.'s accounting for so-called life settlements, which allow life insurance policyholders to cash in their policies while they are still alive, was also improper. Although it is not clear that this reduction will affect its operating income, one analyst said it probably would. That mistake totals \$100 million, A.I.G. said.

Adjustments that A.I.G. said it would make in accounting entries at the parent company - the "top level" entries - are also likely to be deducted from its income. These total \$100 million.

Taken together, the improper accounting points to a \$2.4 billion impact on A.I.G.'s income statement.

Regulators involved in the investigation were surprised by A.I.G.'s conclusion that a reinterpretation of rules for hedge accounting would result in a \$2.4 billion increase in the company's net worth - almost offsetting the \$2.7 billion decrease in net worth.

Representatives from the Securities and Exchange Commission, the New York attorney general's office and the New York State Insurance Department were first briefed last week on the hedge accounting issue and were told that it was a large and complex problem that would require significant time to understand.

But over the weekend, A.I.G., in conjunction with its auditors and lawyers, concluded that a \$2.4 billion increase would be appropriate. One person briefed on A.I.G.'s hedge accounting said the company was able to arrive at a conclusion so quickly because its auditors at PricewaterhouseCoopers chose a method that did not require as much time as A.I.G. originally had thought.

The question investors face, of course, is whether A.I.G. will be able to sustain its growth and hegemony in the insurance world without using accounting gimmickry. "There is clearly risk associated with an investment in shares of A.I.G.," wrote William M. Wilt, insurance analyst at [Morgan Stanley](#), who recommends the stock. "Moreover we do not think the stock will recapture the valuation levels it once enjoyed."

Certainly, Mr. Greenberg's famous complaints about overzealous regulators and A.I.G.'s being above the fray will no longer be heard.

In his letter to shareholders in the company's 2003 annual report, he wrote: "The whole country is paying

a price for the gross misdeeds of relatively few executives who shirked their responsibility to create value for all of their corporate constituencies - shareholders, customers and employees - and abused the system to create wealth for themselves and their close associates. It is unfortunate that the misbehavior of a few companies and their executives could have a negative impact on so many."