Curtis C. Verschoor, CMA, Editor

AIG Remediation Emphasizes Compliance, but not Ethics

Just when we thought that all of the accounting scandals in major corporations had surfaced, along came the announcement by American International Group (AIG) that the SEC and New York State Attorney General (NYSAG) were investigating how AIG had accounted for certain nontraditional reinsurance transactions. AIG had announced only days earlier that earnings for 2004 had increased by 12% and that it had increased its dividend payout by a whopping 67%. AIG also had weathered the adverse publicity engendered by the NYSAG's earlier investigation of the insurance industry with reasonable success. Announcement of the subpoenas upset Wall Street greatly, and AIG's stock tanked, losing some 25% of its value (a portion subsequently has been recovered).

AIG's press announcement of revised financial statements lowered 2004 net income by $1.3 billion, or 12%, and reduced 2004 shareholders' equity by $2.3 billion, or 3%. Explanatory details of the adjustments required 22 pages of narrative and charts in the Management's Discussion and Analysis section of the AIG 2004 10-K, which was incorporated into its Annual Report to Shareholders. An additional, somewhat redundant 23 pages of details of the 2003 and 2002 restatements are contained in Note 2 to the Financial Statements. The effect of the restatement was to reduce net income by more than 10% for the past five years.

The underlying causes of the need for the many adjustments involve AIG's ethical climate. The reasons are set forth in AIG's first Management's Report on Internal Control Over Financial Reporting, the report mandated by the Sarbanes-Oxley Act of 2002. The report discloses a number of material weaknesses in control and emphasizes that the first and most extensive weakness was in the ethical culture of AIG or its control environment. It states:

"Certain of AIG's controls within its control environment were not effective to prevent certain members of senior management, including the former Chief Executive Officer and former Chief Financial Officer, from having the ability, which in certain instances was utilized, to override certain controls and effect certain transactions and accounting entries. In certain of these instances, such transactions and accounting entries appear to have been largely motivated to achieve desired accounting results and were not properly accounted for in accordance with GAAP."

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Specific overrides noted resulted in (1) creation of a special-purpose entity to improperly convert underwriting losses to investment losses, (2) improper recording of reinsurance transactions, (3) improper "top-level" adjustments and covered call transactions, and (4) unsupported "top-level" adjustment of loss reserves.

The fact that earnings for all reported years were restated indicates that these weaknesses were endemic for some considerable period of time. In fact, the press has widely reported that Maurice “Hank” Greenberg, the long-serving chair and CEO of AIG, ruled with an iron hand, exercised complete control over many details, and dominated the board of directors. Greenberg has issued a white paper challenging the rationale for the massive income restatement, pointing to the support of the original reporting by the audit committee and AIG’s long-serving CPA firm, PricewaterhouseCoopers. Whether PwC should have been more aware of the risks inherent in a culture that lacked ethics-related controls will no doubt be adjudicated in the courts. An institutional proxy-advisory firm, Glass Lewis & Co., recommended against retaining PwC “given the magnitude of AIG’s restatement.”

The AIG management report on internal control related remediation efforts emphasizing the need for higher integrity and a culture of ethical values throughout the organization. The report notes:

“AIG has taken, and is developing further plans to take, significant actions to improve its control environment, starting with a clear statement of the tone and philosophy set by its current senior management.”

The Corporate Governance Committee Report in the 2005 AIG Proxy Statement gives further details:

“AIG enhanced its Code of Conduct for employees, mandated that all employees complete formal ethics training, and implemented a Director, Executive Officer, and Senior Financial Officer Code of Business Conduct and Ethics to provide reasonable assurance that all members of the Board of Directors, executive officers, and senior financial officers adhere to the stated principles and procedures set forth in that Code. At the Committee’s recommendation, AIG is developing a corporate-level compliance framework, including implementation of compliance programs at AIG’s major business areas.”

It’s interesting to note that AIG apparently had no previous ethics code that applied to officers and senior management—since the 2004 Proxy Statement was silent on these issues.

In his first letter to shareholders, new CEO Martin J. Sullivan set forth major initiatives to rectify control weaknesses. Under the category of Regulatory Matters, he affirms: “We are working to ensure that every employee in our organization upholds the highest standards.” Also under Regulatory Matters, he notes that all risk management capabilities have been centralized into one risk management department. He also comments on ethics:

“We have also strengthened our compliance function. Employees who have compliance questions or concerns, or have a violation to report, can contact a Compliance Help Line.…We have augmented our ethics education program on a worldwide basis to reinforce the standards set forth in our Code of Conduct.”

It appears that AIG previously had little or no ethics training and no help/hotline, in spite of longstanding requirements for them in the U.S. Sentencing Guidelines.

A major lesson that should be learned from the AIG case is the permeating influence of an organization’s ethical climate. In spite of this, AIG’s promises to improve its compliance and ethics appear only within the context of relationships with regulators and not as a best business practice. As Sullivan’s letter to shareholders notes, also under Regulatory Matters, “We value our reputation…the ethical leadership we exercise…the processes we are implementing…the values we are reinforcing, and the changes we are making to increase transparency and build a constructive relationship with regulators will make AIG a stronger and better company.” Because it was regulators such as the SEC and the requirements of Sarbanes-Oxley that triggered AIG’s establishment of better compliance and ethics programs, AIG seems to be embracing a more ethical structure only because of legal requirements.

A compliance approach to motivating ethical behavior won’t result in the high level of benefits that a values approach will return. Employees, customers, vendors, investors, and the general public all reward companies who successfully put their core values into practice throughout their organization. A legalistic approach may allow an organization to reach the target of compliance, but it won’t hit the center of the bull’s-eye!

Members of the AIG board of directors should clearly focus on their responsibilities contained in the U.S. Sentencing Guidelines to promote an organizational culture that encourages ethical conduct. As set forth in Office of Management and Budget Guidelines for the federal government, organizational culture should be “defined by management’s leadership in setting values of integrity and ethical behavior.”

Good ethics is more than the right thing to do. It’s also a best business practice. ■

Curtis C. Verschoor is the Ledger & Quill Research Professor, School of Accountancy and MIS, DePaul University, Chicago, and Research Scholar in the Center for Business Ethics at Bentley College, Waltham, Mass. His e-mail address is cverscho@condor.depaul.edu.