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AIG's accounting lesson

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The world's largest insurance company shows how to polish a profits statement

A GREAT delusion fostered by recent corporate scandals is that companies will now release results in a way that is comprehensible to more than the few people capable of reading between the lines. Had anyone believed this, AIG, America's biggest insurance company, has produced a tutorial on how a fall in profits can be presented as a small gain, and a small gain as a whopping improvement.

Because of its stature as one of the biggest financial companies, AIG's results have particular resonance in the markets. On February 11th, it trumpeted a 68% increase of net income last year, a figure that was widely reported. The company's stock, which had been steadily rising for three months, leapt up. Struck by the huge gains in profits, David Schiff, who runs an eponymous industry newsletter, *Schiff's Insurance Observer*, took a closer look at the announcement and calculated that if AIG had used the same methodology as it had used in the past, earnings would have been up a respectable, but far less impressive, 15%.

This, in turn, prompted Mr Schiff to take a deeper look at AIG's record. In the fourth quarter of 2002, AIG began its announcement with net income, but then helpfully provided an adjusted number that excluded realised losses on its securities portfolio and a large charge-off for miscalculating previous losses. The upshot was that a 3% increase in net income could, according to AIG, be plausibly viewed as a 12% increase. Mr Schiff says a more plausible case could be made that the various adjustments were superfluous and that, in reality, earnings declined by 4%.

Going back over four years, Mr Schiff concluded that AIG has been able to improve the appearance of its profits growth in 19 out of the past 20 announcements, by shifting the emphasis in its presentation of results between four different measures of profits. It stated net income, of course. But sometimes it offered an adjusted figure highlighting realised investment returns. But not every time. Sometimes it highlighted various losses, at other times, it did not. None of definitions of profits were poor ones. The effect of the switches, however, was to create a far more positive impression of the company's growth.

Providing AIG with the latitude for this numerical dexterity are the “pro forma” calculations that commonly appear at the beginning of company reports, and which do not have to conform to generally accepted accounting principles (GAAP). Done fairly, pro forma numbers provide a clearer path through America's increasingly complex accounting rules. But they can also be used to paint a company's performance in an overly flattering light. This problem is broadly recognised, but present legal constraints have real teeth only in the case of fraud, a high legal hurdle.

Last year, as part of the new Sarbanes-Oxley legislation, the SEC passed rules to crack down on pro-forma abuses. AIG makes reference to the new requirements, noting that its pro forma statements were not in accordance with GAAP, and a reconciliation could be made using subsequent tables. Although this takes work, securities laws do not say that understanding a company must be easy.

AIG also comes under the authority of the New York Stock Exchange, on which it is listed and where, until recently, its chief executive, Hank Greenberg, was a director. As Mr Schiff points out, the NYSE's manual for listed companies states that “changes in accounting methods to mask” unfavorable news “endangers management's reputation for integrity”. The exchange rarely takes action, however, perhaps because the penalties—suspension or delisting—are so draconian. In any case, reporting issues, says the exchange, fall mainly under the SEC's sway. For its part, AIG says that it “always gives a complete accounting of its results that readily enables all interested investors and reporters to compare results with the prior year.”