



**MEMORANDUM**

May 5, 2009

**To:** House Committee on Oversight and Government Reform  
Attention: Leah Perry

**From:** Mark Jickling, Specialist in Financial Economics, 7-7784

**Subject:** **Independent Consultant Reports on AIG Accounting Reforms**

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This memorandum responds to your request for an assessment of several documents sent to the Securities and Exchange Commission (SEC) by James M. Cole, the Independent Consultant to American International Group, Inc. (AIG). The documents include recommendations for improvements in AIG's accounting and compliance practices and several reports monitoring AIG's progress in implementing the recommendations. This memorandum briefly summarizes the accounting scandals that led to the appointment of the Independent Consultant, the scope of the recommendations, and AIG's compliance record as it is described in the Monitoring Reports. Issues that appear relevant to problems with complex derivative contracts experienced by AIG's Financial Products division (and other parts of the company) are highlighted. The memorandum concludes by setting out several questions raised by the Independent Consultant's reports.

## Background

In February 2006, the SEC filed and settled charges against AIG, alleging that the company had committed securities fraud.<sup>1</sup> The settlement was part of a wider resolution of federal and state actions related to allegedly improper accounting, bid rigging and practices involving workers' compensation funds. The Office of the New York State Attorney General, the Superintendent of Insurance of the State of New York and the United States Department of Justice also reached settlements with AIG. AIG agreed to pay over \$1.6 billion to resolve the various claims—of this amount, the SEC received \$800 million, consisting of disgorgement of \$700 million and a penalty of \$100 million. In addition, AIG agreed to undertake corporate reforms designed to prevent misconduct from occurring in the future. Part of the corporate reforms involved the appointment of an Independent Consultant, whose recommendations regarding accounting systems and practices AIG agreed to implement.

The SEC's complaint alleged that certain reinsurance transactions between AIG and General Re Corporation (Gen Re) were not bona fide transfers of risk but were designed to inflate AIG's loss reserves

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<sup>1</sup> SEC, Litigation Release No. 19560, "SECURITIES AND EXCHANGE COMMISSION V. AMERICAN INTERNATIONAL GROUP, INC., Case No. 06 CV 1000 (S.D.N.Y.)," Feb 9, 2006. Online: [<http://www.sec.gov/litigation/litreleases/lr19560.htm>]. Under the terms of the settlement, AIG did not admit to wrongdoing, but agreed not to violate the securities laws in the future.

by \$500 million.<sup>2</sup> This alleged sham transaction came after a 6% drop in AIG's share price following stock analyst concerns that AIG's reserves were declining, as reflected in the company's third quarter earnings release, published on October 26, 2000.<sup>3</sup> The complaint also identified several other transactions in which AIG was accused of materially misstating its financial results through sham transactions and off-the-books entities created to mislead public investors.

The AIG/Gen Re transaction involved Gen Re paying AIG \$500 million in reinsurance "premiums," which AIG reported on its balance sheet as a \$500 million increase in loss reserves. However, since AIG simultaneously agreed to reinsure a \$500 million risk for Gen Re, the transactions were a "wash," with no economic substance. The transactions were instigated following discussions between the two firms' CEOs on about October 31, 2000. AIG's CEO made it clear that he wanted a transaction that involved no risk to AIG (which a real transfer of loss reserves to AIG would have entailed.)<sup>4</sup>

Evidence suggests that in order to conceal the true nature of the transaction, both AIG and Gen Re created a paper trail of false documents to make it appear that Gen Re rather than AIG had initiated the deal.<sup>5</sup>

As a result of these and other transactions, AIG's financial statements for 2000 and later years materially misrepresented the company's earnings. In April 2001, when the company issued its first quarter earnings release, AIG's CEO stated that "AIG had a solid first quarter... We added \$63 million to AIG's general insurance net loss adjustment reserves for the quarter..."<sup>6</sup> The SEC concluded that this increase in reserves was purely an accounting fiction.

These and other transactions described in the SEC complaint suggested a complete breakdown in internal controls over accounting. Management was able to manipulate earnings by creating sham transactions, concealed by false records, apparently without detection for several years.<sup>7</sup> The SEC complaint charges that AIG "knowingly circumvented or knowingly failed to implement a system of internal accounting controls."<sup>8</sup> Accordingly, the court-approved consent agreement included the requirement that an independent consultant be appointed to oversee the remediation of AIG's accounting systems.

## The Independent Consultant's Recommendations

AIG retained James M. Cole as Independent Consultant on November 16, 2006, as required by the consent order. The consultant was to make recommendations regarding best practices for accounting and a range of regulatory, legal, and compliance functions. Three reports containing recommendations were issued in August and September of 2007.

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<sup>2</sup> SEC, "Securities and Exchange Commission, Plaintiff, Against American International Group, Inc., Defendant," Complaint filed Feb. 9, 2006 (Case No. 06 CV 1000 (S.D.N.Y.)). Online: [<http://www.sec.gov/litigation/complaints/comp19560.pdf>]. (Hereinafter cited as "SEC Complaint.")

<sup>3</sup> SEC Complaint, p. 9.

<sup>4</sup> Ibid.

<sup>5</sup> SEC Complaint, p. 15.

<sup>6</sup> SEC Complaint, p. 18.

<sup>7</sup> The SEC reached consent agreements with AIG regarding other accounting improprieties in 2004 and 2005. A 2005 restatement of earnings found 66 items that had been improperly accounted for, including the Gen Re transactions discussed above.

<sup>8</sup> SEC Complaint, p. 28.

## The August 31, 2007 Report

The Independent Consultant's mission did not include investigation of past misconduct. The reports are entirely forward looking; they set out a range of best practices that encompass virtually all of the company's compliance and reporting obligations. It is almost as though the Independent Consultant assumed that AIG had no internal compliance or accounting systems whatsoever and proceeded to draw them on a blank slate. The first report notes that AIG had already undertaken a substantial number of remedial steps that may have fulfilled some of the recommendations.<sup>9</sup>

The first set of recommendations, dated August 31, 2007, addresses (1) the structure and process of AIG's compliance program, (2) internal controls as defined by section 404 of the Sarbanes-Oxley Act, (3) the remediation of certain deficiencies noted by AIG's outside auditor, (4) training for executives, officers, and employees involved in accounting and financial reporting, (5) the structure of AIG's internal Disclosure Committee, and (6) the Internal Audit Division.

### Compliance

The first group of recommendations deal with the role of the chief corporate compliance officer and Office of Compliance. There is an enumeration of the types of risk that AIG faces—market risk, credit risk, strategic risk, reputational risks, and operational risk (including, but not limited to, compliance risk).<sup>10</sup> One could argue that AIG's collapse in 2008 reflected a failure to manage any of these risks successfully. The Independent Consultant's report, however, does not include specific recommendations for managing these financial risks; rather, it deals with the processes by which risk evaluations at the individual business unit level are passed up the chain to the corporate risk management staff, and how the central staff works with the local unit to design appropriate risk controls. Other topics include disciplinary procedures and investigative protocols for compliance incidents.

### Sarbanes-Oxley

The second set deals with Sarbanes-Oxley section 404, which requires the CEO and CFO of publicly traded firms to certify (on their annual reports) that they are responsible for internal accounting controls, and also requires the outside auditor to issue an opinion on the soundness of those controls. Here the Independent Consultant defers to the auditor, finding it appropriate to rely on the auditor to identify deficiencies and material weaknesses in accounting controls.<sup>11</sup>

The report sets out a number of recommendations to deal with areas where the company or the outside auditor identified problems. There are eight such areas.

### Internal Controls

In its 2004 annual report (From 10-K filed with the SEC), AIG identified a material weakness relating to integrity of the control environment, which enabled senior management to override controls and effect certain transactions and accounting entries. The related recommendations are very broad, and are

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<sup>9</sup> "Recommendations of the Independent Consultant to American International Group, Inc., August 31, 2007," p. 1.

<sup>10</sup> *Ibid*, p. 6.

<sup>11</sup> *Ibid*, p. 13.

expressed in terms of sweeping objectives, for example, “preparation of reliable, accurate published financial statements.”<sup>12</sup> This weakness was classified as “remediated” in the 2005 annual report.<sup>13</sup>

## Risk Transfer

The 2004 10-K identified a material weakness related to accounting for risk transfer, arising from the AIG/Gen Re and similar transactions. The recommendations do not appear to address particular weaknesses or circumstances that allowed these transactions to be misrepresented. Instead, there is another set of very broad objectives to be met by formal policies intended to ensure that accounting decisions follow GAAP and company policy, are properly documented, that accounting for significant non-standard transactions is approved by the Office of Accounting Policy, and that staff is properly trained, receives appropriate feedback, and is sufficiently monitored.<sup>14</sup>

The 2005 10-K reported this deficiency as remediated.

## Balance Sheet Reconciliations

The 2004 10-K identified a material weakness related to a lack of “effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of AIG’s operations, principally in the Domestic Brokerage Group. Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium receivables, reinsurance recoverables and intercompany accounts. As a result, insurance acquisition and other operating expenses, premiums and insurance balances receivable, reinsurance assets, other assets and retained earnings were misstated under GAAP.”<sup>15</sup>

The recommendations are similar to those for risk transfer above: create a formal policy, with detailed instructions on how to perform reconciliations, monitor the overall reconciliation process, and follow the relevant FASB standards to avoid distorting reported earnings. This material weakness persisted through 2005, and was downgraded to the status of a “significant deficiency” in the 2006 10-K.

## Derivative Hedge Accounting

The 2004 and 2005 10-Ks identified as a material weakness the controls over the decision whether a derivative transaction qualified for hedge accounting treatment (which means that changes in the derivative’s fair value would not be reported as current income) or whether the transaction should be treated as a speculative trade (and changes in the instrument’s value reported in current income).<sup>16</sup>

AIG’s crisis in 2008 was triggered in substantial part by failure to measure risk in credit derivatives. It should be noted, however, that this deficiency did not address the inability to measure the value of a derivative, but merely the correct application of the standard (FAS 133) that governs the accounting treatment of changes in derivatives’ value. Still, compliance with FAS 133 does presume that firms are able to set an accurate fair value on derivative assets.

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<sup>12</sup> Ibid, p. 15.

<sup>13</sup> Ibid, p. 14.

<sup>14</sup> Ibid, pp. 20-28.

<sup>15</sup> Ibid, p. 29.

<sup>16</sup> Ibid, pp. 35-43.

The Independent Consultant's recommendations included creation of a formal guiding policy, including a document providing examples of each permissible use of hedge accounting, retention of personnel knowledgeable about FAS 133, and Office of Accounting Policy approval for new hedging strategies before implementation.

Two recommendations applied specifically to AIG's Financial Products division (AIG-FP):

- establish controls to provide reasonable assurance that AIG-FP captures the transactional data necessary to properly account for derivative transactions in compliance with FAS 133; and
- develop an automated solution that allows for the application of hedge accounting for AIG-FP's hedging relationships in a systematic and controlled manner and in accordance with the requirements of FAS 133.

The material weakness was identified as remediated in the 2006 10-K.

### **Income Tax Accounting**

Accounting for income taxes was identified as a material weakness in the 2004, 2005, and 2006 10-Ks. In other words, the issue had not been resolved to the satisfaction of AIG and its auditor at the time the Independent Consultant issued his August 31, 2007 recommendations.

The recommendations called for centralized oversight, better record-keeping, qualified internal personnel and external tax service vendors, and limits on the numbers of legal entities (which introduce complexity into tax reporting).

### **Accounting Policy**

Accounting policy was identified as a significant deficiency in the 2004, 2005, and 2006 annual reports. The deficiency arose as a result of AIG's failing to continually update its accounting policy manual for new pronouncements (and guidance on existing pronouncements). In addition, the accounting policy function was inadequately staffed and viewed as a research function rather than a control function. AIG also failed to maintain contemporaneous documentation regarding the resolution of accounting issues.<sup>17</sup> Twenty-six pages of recommendations call for the creation of new offices and structures within the company, and for an increase in resources devoted to accounting.

### **Legal Contingencies**

Identified as a significant deficiency in 2004, and remediated in 2005, was legal contingencies: "a result of ineffective lines of communication between corporate (both corporate legal and corporate comptrollership) and the Standard Internal (SI) reporting package companies regarding the reporting of legal matters with potential financial reporting or disclosure ramifications. [AIG] failed to provide proper channels and guidance to SI reporting package companies to facilitate communication of legal contingency issues with corporate comptrollership and corporate legal."<sup>18</sup>

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<sup>17</sup> Ibid, p. 50.

<sup>18</sup> Ibid, p. 78.

Recommendations include the selection of accounting policies for reporting legal contingencies in conformity with the relevant FASB standards, provision of training to employees and clear lines of communication from staff to the Board of Directors, and preparation of a formal litigation report at the central corporate level.

## Logical Access Controls

AIG's "failure to consistently address issues regarding the ability to sufficiently control and monitor access to systems, data, transactions, and computing resources"<sup>19</sup> was cited as a significant deficiency in the 2004, 2005, and 2006 10-K reports. Related recommendations included formulation of policies to restrict access to information systems to authorized users and the creation of a new oversight office and an information security management position.

## Training

The August 31, 2007 report also addresses portions of the consent order that called for training for "mandatory participants," including corporate officers, executives, and employees with responsibility for oversight of accounting and financial reporting functions, as well as legal division employees involved with oversight of accounting, disclosure, and compliance. The training was to cover:

- obligations under the securities laws;
- proper internal controls and procedures;
- discovering and recognizing improper, non-GAAP accounting; and
- responses expected upon learning of improper, illegal, or potentially illegal acts.<sup>20</sup>

The report notes that AIG had held a training conference in October 2006 which had largely met its obligation. The recommendations include ongoing training sessions for new employees or existing employees who move into one of the "mandatory participant" categories.

## Disclosure Committee

The report includes recommendations for the composition and role of the disclosure committee (an internal committee made up of executives and employees, not a committee of the board of directors). Membership should include not just key management personnel, but seasoned and knowledgeable business and accounting professionals. The committee should have clear access (direct or indirect) to the CEO or CFO.<sup>21</sup>

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<sup>19</sup> Ibid, p. 89.

<sup>20</sup> Ibid, p. 94.

<sup>21</sup> Ibid, p. 98.

## Internal Audit Division

Finally, the report calls for strengthening the internal audit division (IAD). The report recommends that the IAD should have sufficient resources, and should report operationally to the Audit Committee of the board of directors, which should determine its mandate and budget.<sup>22</sup>

## The September 14, 2007 Report

The September 14, 2007 report contains recommendations regarding record keeping and management.<sup>23</sup> The report does not analyze any weakness or failures at AIG in this area, but simply proposes a multi-level corporate organizational structure. At the top would be a Records and Information Management (RIM) organization, headed by a newly-established Chief Records Office. There would also be a RIM Coordinating Council, to oversee regional records managers and local records coordinators. The report also calls for establishment of a new records management policy.

## The September 30, 2007 Report

The September 30, 2007 report contains recommendations that concern specific aspects of AIG's compliance program, whistleblower provisions, and corporate governance structure.<sup>24</sup> These issues are addressed at a high level of generality; the Independent Consultant does not recommend specific policies and procedures that AIG should adopt, but rather "some of the basic components that should be included in AIG's policies."<sup>25</sup> These recommendations are meant to supplement the recommendations included in the August 31, 2007 report.

For the most part, the issues identified—not intended to be an exhaustive list<sup>26</sup>—do not appear to be directly relevant to the collapse of AIG-FP in 2008. They are meant to have an exemplary value, beyond specific policy areas: the report notes that they concern "the overall structure and process for AIG's compliance function."<sup>27</sup> The report calls on AIG to be mindful of four important components:

- the need for the compliance function to be independent from management;
- the equally important need for the compliance function to work with management to facilitate the success of the business in a legally compliant manner;
- the need to have the compliance function reside in the Local Operating Companies and to have supervision and support present in the local geographic areas; and
- the need to have each compliance program respond not only to U.S. law, but also to the local legal requirements of the jurisdictions in which it operates.<sup>28</sup>

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<sup>22</sup> Ibid, p. 99.

<sup>23</sup> "Recommendations of the Independent Consultant to American International Group, Inc. Regarding Records Management, September 14, 2007," 17 p.

<sup>24</sup> "Recommendations of the Independent Consultant to American International Group, Inc. Regarding Records Management, September 30, 2007," 90 p.

<sup>25</sup> Ibid, p. 1.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid.

One recommendation raises interesting issues about the relationship between AIG and AIG-FP. Recommendation EC-2 deals with the Derivatives Committee, whose function is to prevent the recording of transactions in a manner not consistent with GAAP.<sup>29</sup> The Independent Consultant recommends that the Derivatives Committee provide an independent review of derivatives transactions entered into by all AIG entities *except AIG-FP*. The report then calls for an “appropriate independent review” of proposed AIG-FP contracts, to be conducted by AIG-FP itself.

The report does not include any explanation for this separate treatment of AIG-FP. It should be noted that the recommendation addresses the accounting treatment of derivatives, rather than the financial risks to the company that they might pose, but it does suggest that AIG-FP enjoyed an unusual degree of autonomy within AIG’s overall corporate structure.

## The Independent Consultant’s Interim Report

The interim report of April 10, 2008, sets out the areas of AIG’s operations that the consent order requires the Independent Consultant to monitor.<sup>30</sup> These are:

- AIG’s internal controls over financial reporting;
- the organization and reporting structure of AIG’s Internal Audit Division and AIG’s Disclosure Committee;
- the policies, procedures, and effectiveness of AIG’s regulatory, compliance, and legal functions, including the operations of any committees established to review and approve transactions or for the purpose of preventing the recording of transactions or financial reporting results in a manner inconsistent with Generally Accepted Accounting Principles;
- AIG’s records management and retention policies and procedures;
- the adequacy of whistleblower procedures designed to allow employees and others to report confidentially matters that may have bearing on AIG’s financial reporting obligations;
- AIG’s training and education program;
- corporate governance reforms implemented by AIG’s Board of Directors; and
- the adequacy and effectiveness of AIG’s remediation plan relating to its internal controls over financial reporting.<sup>31</sup>

The interim report notes that AIG accepted virtually all the Independent Consultant’s recommendations, with only a few minor modifications.<sup>32</sup>

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<sup>29</sup> Ibid, p. 87.

<sup>30</sup> “Interim Report of the Independent Consultant to American International Group, Inc., April 10, 2008,” 9 p.

<sup>31</sup> Ibid, pp. 1-2.

<sup>32</sup> Ibid, p. 5.



# The Independent Consultant's Monitoring Reports

## The May 15, 2008 Report

On May 15, 2008, the Independent Consultant issued the first monitoring report.<sup>33</sup> The reporting format—followed (with some modifications) in the later monitoring reports as well—is based on a three-color scheme: green means implementation is on-track; yellow indicates that caution is warranted; and red means that implementation is off-track.

In the May report, all recommendations are marked green, with the exception of those that deal with records management, the subject of the September 14, 2007 report. This does not mean that all other recommendations have been followed and implemented, merely that AIG has at least put forward an implementation plan. The Independent Consultant found that AIG had worked diligently and deserves commendation for its efforts to date.<sup>34</sup>

In the area of records management, the report notes that AIG had been off-track, because of personnel issues. The report notes recent improvement, however, and the records-related recommendations are given a grade of “yellow.”<sup>35</sup>

## The August 15, 2008 Report

The August 2008 monitoring report notes that AIG faced increased challenges in the implementation of the Independent Consultant's recommendations, due to the departure of the CEO, CFO, and Chief Compliance Officer.<sup>36</sup> In general, the report is not critical of AIG's implementation efforts. Where recommendations are graded yellow, the reason is usually personnel turnover.

The records area, which was singled out for concern in the May 2008 report, now has several areas graded red, or “off-track.” The report notes that many positions in the new Records and Information Management organization had not been filled, nor had the organization's budget been approved. The coordinating, regional, and local entities had not been formed. The post of Chief Records Officer had been filled briefly, but was then vacant.<sup>37</sup>

Recommendations regarding accounting policy for non-standard and significant transactions<sup>38</sup> and derivatives hedge accounting<sup>39</sup> were both scored green.

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<sup>33</sup> “May 2008 Monitoring Report of the Independent Consultant to American International Group, Inc., May 15, 2008,” 51 p.

<sup>34</sup> *Ibid.*, p. ii.

<sup>35</sup> *Ibid.*, p. 33.

<sup>36</sup> “August 2008 Monitoring Report of the Independent Consultant to American International Group, Inc., August 15, 2008,” p. i.

<sup>37</sup> *Ibid.*, p. 35.

<sup>38</sup> *Ibid.*, p. 40.

<sup>39</sup> *Ibid.*, p. 47.

## The November 15, 2008 Report

The November monitoring report begins by noting that “AIG has entered into what can only be described as a crisis scenario.”<sup>40</sup> As a result, normal operations had been disrupted and efforts to implement the Independent Consultant’s recommendations had been significantly curtailed. The prospect of AIG emerging from its period of government assistance as a much smaller firm raised questions about the appropriateness of many of the recommendations, which had been crafted with a large international corporation in mind.

As a result of the chaos in AIG, many recommendations are described as “on hold.” The Independent Consultant announced his intention to meet with AIG every two months to determine whether the situation had stabilized sufficiently to permit the implementation of those recommendations to resume.<sup>41</sup>

## The March 31, 2009 Report

The Independent Consultant’s latest monitoring report was issued on March 31, 2009.<sup>42</sup> The color rating scheme is abandoned and the original recommendations are set aside in favor of streamlined monitoring of a scaled-back set of recommendations.

The report notes that AIG petitioned the SEC, the New York Attorney General’s Office, and the New York Department of Insurance to have all monitoring by the Independent Consultant suspended for six months. The request was not granted.<sup>43</sup> Instead, the Independent Consultant formulated a January 2009 Work Plan, which set out its monitoring activities. These appear to consist primarily of meetings with senior AIG officials, including the General Counsel and the Chief Compliance Officer (who was also serving as interim Chief Records Officer).

Part V of the March report includes the Independent Consultant’s assessments of AIG’s implementation progress. The report noted the following concerns:

- the independence of compliance and business functions was often compromised;
- compliance staff was often assigned additional duties;
- the Independent Consultant could not determine the extent to which business personnel had participated in the compliance risk management process;
- compliance policies and procedures were not always tailored to the needs of local business units;
- AIG could not explain its own (or its auditor’s) monitoring of compliance risk; and
- training scheduled for the first quarter of 2009 had been postponed until the third quarter.

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<sup>40</sup> “November 2008 Monitoring Report of the Independent Consultant to American International Group, Inc., November 15, 2008,” p. i.

<sup>41</sup> *Ibid.*, p. ii.

<sup>42</sup> “March 2009 Monitoring Report of the Independent Consultant to American International Group, Inc., March 31, 2009,” 27 p.

<sup>43</sup> *Ibid.*, p. 2.

The report repeatedly expresses sympathy for the difficulty of implementing these policies in the current environment. In a number of areas, AIG's progress is described as satisfactory, or the implementation as completed. These include global risk compliance policies, procedures for escalating and investigating compliance issues, and an e-mail from the CEO advising all personnel of the need to comply with applicable laws and policies during reorganization.

The March report raised an issue that was not discussed in previous reports, dealing with accounting for credit default swaps (CDS). The report noted that AIG did not consider CDS to be "significant" or "non-standard" transactions. Company policy was that transactions so identified would be subject to more stringent accounting controls and brought to the attention of the Office of Accounting Policy (OAP).

The Independent Consultant concludes that the failure to treat credit swaps as significant and non-standard transactions creates:

a gap that we recommended be closed. AIG informed us that the financial reporting for credit default swaps ("CDS") had been viewed as very standard and thus was not identified as the kind of "significant" and "non-standard" transaction that needed to be reviewed by OAP. AIG ended up having a material weakness in its valuation process for its CDSs that had an impact on its financial reporting. In normal times, with normal, active markets, CDSs were easily valued, and therefore were not viewed as "non-standard" transactions. However, when that market fell apart, and there were no readily available marks to use to value the CDSs and the underlying instruments, this became very "non-standard," and the valuation process related to those instruments that affected financial reporting should have been reviewed by OAP. Given the magnitude of harm that can occur if "significant" and "non-standard" transactions are not correctly identified, we continue to believe that it is important that AIG provide additional guidance in this area. [AIG] has agreed to discuss this matter with us.<sup>44</sup>

## Concluding Observations

The appointment of the Independent Consultant in 2006 followed several investigations that found AIG's accounting controls to be extremely weak and incapable of preventing alleged manipulation and fraud instigated by senior management. Arguably because the problems appeared to be so systematic and deep-rooted, the Consultant's recommendations did not focus on a handful of problem areas, but instead appeared draw up an "ideal" compliance structure based on best practices. Given that monitoring of implementation is now constrained, it is hard to tell how much of AIG's previous accounting and compliance systems actually would have needed to be modified or replaced.

The extent to which accounting problems played a part in AIG's 2008 crisis is difficult to gauge. The alleged frauds investigated in 2004-2006 did not necessarily indicate weakness in AIG's technical accounting capabilities: it can be argued that AIG knew exactly what its true financial condition was but chose to report something else. On the other hand, it is also reasonable to argue that control fraud is less likely to occur in companies with strong internal controls over accounting and reporting.

The question of whether fraud was involved in AIG's 2008 collapse will likely be litigated extensively. Were problems in AIG-FP recognized early enough? If they were not, the failing may be in accounting

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<sup>44</sup> Ibid, pp. 22-23.

capability. If they were, the question becomes whether they were disclosed in timely fashion, as required by the securities laws.

While the Independent Consultant's reports generally focus on accounting for risk rather than risk itself, in derivatives trading the two are cannot be separated. That is, since complex and non-standard derivatives contracts generally have no active trading market, they can only be priced with reference to the trader's model. The same model is used both to determine accounting fair market valuations and to guide trading decisions. AIG's sorry accounting history certainly suggests the possibility that weakness in corporate accounting culture may have spilled over into poor trading risk management. This hypothesis is weakened by the finding that nearly every other large financial firm in the world seems to have made similar mistakes in pricing risk before the current financial crisis erupted.

## Suggestions for Hearings Questions

(1) Best practices identified by the Independent Consultant included that AIG have each subdivision (LOC, segment, business unit, etc.) conduct an annual comprehensive risk assessment that will include the appropriate business and risk function personnel (RA 01.1). Yet, AIG had made 0% progress in this category by May 2008, even though Bear Stearns had already failed. Progress began to be made in Fall of 2008. The March 2009 monitoring report said of risk assessment (RCSA process), "we found it to be a good process, although, as noted by AIG, it was a new process and it needed to mature over the next few years." That same March 2009 report went on to say that the Independent Consultant could not ascertain the extent to which business personnel participated in compliance of risk assessment. "This is an important aspect of the process."

To what extent were the views of business personnel regarding risk assessment (1) made known to higher-level management and (2) properly disclosed, either internally or to outside investors? Do we know if there were business personnel with direct knowledge of AIG's exposure to various market risks that attempted to raise an alarm, or were AIG's business personnel under the belief that market risks were being appropriately managed?

(2) The Cole reports seem to focus mostly on disclosure and compliance issues. Did AIG conduct external audits of its substantive risks? If so, what were the results?

(3) The Independent Consultant's reports called for across-the-board improvements in accounting and compliance systems. Did weaknesses in accounting and compliance enable excessive risk-taking at AIG-FP?

(4) The Independent Consultant's reports suggest that certain derivatives transactions at AIG-FP were subject to less internal oversight than similar transactions at other company units. Who was responsible for this policy?

5) To what extent are you (both the Trustees and Mr. Liddy) familiar with the Cole reports? Do you consider them useful references in the future restructuring of AIG?

(6) Mr. Liddy, have you taken any direct action to fulfill the recommendations in the Cole reports? To any extent that you have not, is this due to the immediate crises taking precedence and thus you intend to fulfill these recommendations in the future? Or have the reports in general been overtaken by events?

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(7) In your (Mr. Liddy) estimation, were the problems that prompted the consent agreement and subsequent Cole reports a function of AIG's corporate culture? How would you describe the corporate culture you found at AIG compared to the other companies you have been involved with?