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Developing Risk Skills: An Investigation of Business Risks and Controls at Prudential Insurance Company of America

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ABSTRACT: The Prudential Insurance Company was involved in the largest life insurance churning scam of the 1980s and early 1990s. At the time, Prudential had weak business controls, and its corporate culture was characterized as ineffective and loose. However, this scandal is rooted in something deeper than a poor control environment. Prudential was a company facing several risks; many company decisions allowed these risks to have a dramatic impact on the company. As a result, its weak control environment came to the forefront, allowing the churning scam to reach its record levels. This case demonstrates the value of identifying and assessing risks in an organization. Further, the case demonstrates how to build control solutions to match the risks. Learning how to manage risks is a valuable skill for business professionals. In fact, the AICPA's Special Committee on Assurance Services (AICPA 1997), also known as the Elliott Committee, identified risk assessment as one of the emerging assurance services offered by CPAs.

"Let's get beyond the word 'insurance.' Let's don't be concerned with what we call a plan. Let's just look at the end result."
—Prudential Training Video (*ABC NewsPrimetime Live* 1996)

Prudential Insurance Company of America, whose symbol is the Rock of Gibraltar, assures its customers that "for financial security and peace of mind" they could depend on the Rock (Prudential 1993 Annual Report, 5). For years its advertisements built its "ROCK-SOLID" image (Prudential 1991 Annual Report, 5). Prudential (the Rock) was created around its people, who were committed to a set of core values lauded by management: client focus, winning,

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trust, and respect for each other. The company was dedicated to "selling the right product, to the right client, in the right way" (Parsons and Engdale 1995, 12–13). Yet for Prudential's customers, selling the right product in the right way proved to result in something less than "peace of mind."

The Nicholsons' Story

Keith and Carol Nicholson trusted their financial security to the Rock when they purchased a rather sizable life insurance policy from their Prudential agent. At one point, the policy's cash value was $103,000 (*ABC News Primetime Live* 1996). Since Keith suffered from leukemia, this policy was comfort for the unstable times that lay ahead of them. Carol Nicholson needed to know that this money was going to be there.

Carol had been known to say that she trusted her Prudential agent as she trusted her pastor. He was going to play a vital role in smoothing a very uncertain future. Therefore, when her agent suggested that she and her husband take out a new life insurance policy on Keith "at no additional cost," the couple agreed, no questions asked. They just signed the forms, believing that they had brought even more certainty to the unpredictable future.

Eventually, Keith succumbed to leukemia. Much to Carol's surprise, the six-figure nest egg that she thought would be awaiting her was now a mere $22,000 (*ABC News Primetime Live* 1996). Carol's agent had not been honest when he had Carol and her husband change his life insurance policy. The Nicholsons' agent had taken advantage of the couple's trust by having them borrow against their old policy to purchase a new and more expensive policy.[1] Without even realizing it, Carol and Keith had signed a blank withdrawal form that allowed their agent to raid the cash value of the old policy to begin to pay for the new policy. Carol Nicholson's only reaction was a tearful plea of "How could they?"

The Nicholsons' Problem: A Decade in the Making

Prudential is a massive entity whose asset base is equivalent to the economy of Sweden (see Exhibits 1 and 2). In late 1994, Prudential's primary businesses were life insurance, health care, investments, and property and casualty insurance.

[1] Such a tactic is referred to as a "churning," "financing," or "refinancing."

EXHIBIT 1
Top 10 Life/Health Insurers in 1990
Ranked by Assets

Ranking	Company Name	1990 Assets (in billions)	% of Total Industry
1	Prudential Ins. Co. of America	$133.5	8.7
2	Metropolitan Life Ins. Co.	103.2	6.7
3	Aetna Life Insurance Co.	52.3	3.4
4	Equitable Life Assurance Soc.	50.3	3.3
5	Teachers Ins. & Annuity Assoc.	49.9	3.2
6	New York Life Insurance Co.	39.9	2.6
7	Connecticut General Life Ins. Co.	37.4	2.4
8	John Hancock Mutual Life	33.7	2.2
9	Travelers Insurance Co.	33.0	2.2
10	Northwestern Mutual Ins.	31.4	2.0

Source: *Best's Review*, July 1991.

EXHIBIT 2
Life Insurers Ranked Based on Premium Income

1990 Ranking	Company Name	1990 Premium (in billions)	1989 Ranking	1980 Ranking
1	Prudential Ins. Co. of America	$ 24.1	1	1
2	Metropolitan Life Ins. Co.	19.5	2	2
3	Aetna Insurance Co.	9.6	3	3
4	New York Life Insurance Co.	7.7	4	6
5	John Hancock Mutual Life	6.8	5	7
6	Principal Mutual Life	6.5	6	9
7	Travelers Insurance Co.	4.9	7	5
8	Lincoln National Life Ins. Co.	4.8	9	20
9	Massachusetts Mutual Life Ins.	4.5	16	13
10	Connecticut General Life Ins. Co.	4.4	22	8

Source: *Best's Review*, July 1991.

EXHIBIT 3
Prudential's Total Life Insurance Sales 1982–1987

Year	Total Life Insurance Sales (in millions)
1982	$59,779
1983	65,854
1984	66,645
1985	80,167
1986	87,312
1987	92,654

Source: 1987 Prudential Annual Report. Note that this breakout of life insurance sales numbers is not available for other years.

Of all the different types of insurance being offered by Prudential and its competitors, life insurance was the most lucrative for both the company and its agents. From 1983–1987, Prudential saw record-breaking increases in its sales of life insurance policies (see Exhibit 3), even though the industry saw a decline in sales (see Exhibit 4).

Carol and Keith Nicholson were not the only victims of Prudential's churning scam. Before the end of 1995, over 10.7 million life insurance policyholders had allegedly fallen prey to the scam and a class action lawsuit was soon filed. Additionally, investigations of the nation's largest life insurer spanned the country, from New Jersey to Florida to Arizona, in an effort to answer the question, "How could they?"

In 1996, as part of the Florida Department of Insurance's investigation of Prudential, a former Prudential Vice-President of Regional Marketing testified regarding sales practices. In part of his testimony, the witness discussed the process of how customers buy life insurance (Florida Department of Insurance 1996b, 29).

> **WITNESS:** They said that their agent sits there, and he says sign there, sign here, sign here, sign here, and I have to trust in the agent. I sign, he turns it over and says sign here, sign here, and sign here. I sign.

EXHIBIT 4
Industry Life Insurance Purchases in the United States
(policies and certificates in thousands, amounts in $ millions)

	Individual		Group		Total	
Year	Policies	Amount	Certificates	Amount	Policies	Amount
1960	21,021	$ 59,763	3,734	$ 14,645	24,755	$ 74,408
1965	20,429	90,781	7,007	51,385	27,436	142,166
1970	18,550	129,432	5,219	63,690	23,769	193,122
1975	18,946	194,732	8,146	95,190	27,092	289,922
1980	17,628	389,184	11,379	183,418	29,007	572,602
1981	17,629	484,412	11,923	346,702	29,552	831,114
1982	16,964	587,342	11,930	250,532	28,894	837,874
1983	18,571	754,832	13,450	271,609	32,021	1,026,441
1984	18,407	821,258	14,605	293,521	33,012	1,114,779
1985	17,637	911,666	16,243	319,503	33,880	1,231,169
1986	17,116	934,010	17,507	374,741	34,623	1,308,751
1987	16,455	986,984	16,698	365,529	33,153	1,352,513
1988	15,798	996,006	15,793	410,848	31,591	1,406,854
1989	14,850	1,020,971	15,110	420,707	29,960	1,441,678
1990	14,199	1,069,880	14,592	459,271	28,791	1,529,151
1991	13,583	1,041,706	16,230	573,953	29,813	1,615,659
1992	13,452	1,048,357	14,930	440,143	28,382	1,488,500
1993	13,664	1,101,476	17,574	576,823	31,238	1,678,299
1994	13,894	1,107,448	18,061	549,984	31,955	1,657,432
1995	13,830	1,101,349	18,105	499,024	31,935	1,600,373
1996	12,333	1,118,451	17,575	581,366	29,908	1,699,817

Source: American Council of Life Insurance and LIMRA International.

> Most people, even after they signed them, didn't take them home and read them. That is what it's like applying for life insurance.

The Nicholsons were among the many insurance customers who just signed forms as instructed by their agent. According to this ex-Prudential employee, the most prevalent financing scam at Prudential was selling a new policy as "free life insurance" by essentially using the accumulated cash value of an older policy to pay the new, increased premiums. In many cases, the old "whole life" or "universal policy" was replaced with a "term" policy. The former policies build up cash value, whereas "term" policies do not. In some cases, insured persons would increase their total life insurance coverage because they had more overall coverage from the term policy. In his two days of testimony, the confidential witness commented as follows (Florida Department of Insurance 1996a, 53):

> **WITNESS:** I would say financing was minuscule in '82, '83, '84—and then started growing rapidly in '85, '86, '87, '88, and then started to level off probably in '90, '91, '92, and then may have gone down a little bit in '93, '94.

Prudential contended that such practices were never condoned. Under oath, the ex-employee stated otherwise (Florida Department of Insurance 1996a, 13):

> **WITNESS:** That has always been Prudential's public statement, financing and replacement is bad; not generally in the best interests of the

policyholder....At the peak, it was used in at least 30 percent of the cases and probably higher.

According to a Coopers & Lybrand's (1994, 5) assessment of Prudential's controls:

> Training of field management with respect to supervising sales practices and identifying and dealing with compliance-related issues has been inconsistent at best. As such, managers are not always sure as to what constitutes "good" vs. "'bad'" sales practices, are reactive toward compliance issues, and are not held accountable for their own actions or those of their representatives.

Prudential Insurance, like many life insurers during this period (1982–1993), offered a very complex product. Without adequate instruction, many agents felt as if they had been misled about what they were selling. Even so, it should be noted that many Prudential employees were fully aware of the consequences of their actions. The deposed former employee noted that there existed an informal system of training on refinancing policies. The witness told how this manipulative practice was able to spread (Florida Department of Insurance 1996a, 54):

> **WITNESS:** What happens is because there is no formal training of this kind of thing, it passes by word of mouth or by transfer of people. So it doesn't surprise me that you will find it pop up here or pop up there. Then after these people got to be very successful, they would go to conferences and say, 'this is how we do it.' And then it spread countrywide, and my belief is it really got heavy in '84 and '85 because illustration sold so nicely, too.

The ex-employee remarked that many agents set up booths at the Regional Business Conference in an effort to "illustrate" the art of selling financed insurance (Florida Department of Insurance 1996b, 55). The employee also claimed that, in support of these practices, many agents developed and used their own sales materials, as revealed by testimony on these self-developed materials (Florida Department of Insurance 1996b, 54 and 56):

> **QUESTION:** Typically, would he [management] say anything about it? Would he care?
>
> **WITNESS:** I don't know. I'm not sure. But keep in mind that the managers are paid overrides. If there is a piece that appears to be working, they're not going to stop using it, because it affects their pocketbook.

The former Prudential worker also discussed the monetary consequences of churning (Florida Department of Insurance 1996a, 14–16):

> **QUESTION:** So...this document [a memo] would indicate that the company knew way back in '76 that financed insurance was regularly producing unacceptable results?
>
> **WITNESS:** Correct. And the next question is why it was producing unacceptable results. Did you [Prudential] look into it? Did you [Prudential] ascertain what occurred in the sale that produced unacceptable results? The answer is nothing. The reason that Prudential didn't care was they were sales driven. Everything was measured off new sales....There was a benefit to the agents, to management, to individuals working for the company, because their bonuses grew dramatically...

> If you look at the pay scale of management in 1976, a senior vice president in 1976 probably made $100,000 a year, a lot of money. A senior vice president in the company today probably in the same position might make a million dollars a year. Now inflation has been eating away a lot since 1976, but I don't think it ate ten times....So there was a financial incentive for the employees, all employees, not just senior people.

The incentive for the salesperson was simply commissions. Characteristically, a large percentage of the premium paid by the consumer in the first year went directly to the agent. That commission shrunk in later years. The ex-employee further elaborated upon this subject in the second day of his testimony (Florida Department of Insurance 1996b, 3 and 49):

> **WITNESS:** Another file you would want to look at is Phoenix West. That was an investigation done last year [1995]....As a result of that investigation there were recommendations with regard to the discipline of many, many people; but if you look at that whole investigation, you will see the attitude of the company toward people who were engaged in wrongful financial insurance transactions over a long period of time, with the knowledge of many people...They merely state that we did it because we made money and we didn't care....And Phoenix West is just a microcosm of what was really going on in the country.

John Vetter, an insurance representative in the beleaguered Phoenix West Agency, admitted to some questionable sales. In an investigation of the Phoenix West Agency, the Florida Department of Insurance (Parsons and Engdale 1995, 7) documented that:

> He [Vetter] said your judgment gets clouded out in the field when you are pressured to sell, sell, sell. In response to questions on how he could explain a case where he had rewritten a policy instead of reinstating it when the rewrite resulted in a higher premium for the insured, he responded that it was "pure greed."

With everyone in Prudential benefiting financially from refinanced life insurance policies, there seemed to be no need to stop, regardless of management's "official" stance on the issue (Florida Department of Insurance 1996a, 9):

> **WITNESS:** You will probably see that in Prudential all the documents that you see or the bulk of the documents you see will be very good on their face, they'll say "you shall not do this." The problem was that there was nothing behind "you shall not do this." There was no mechanism to punish. In fact, I don't believe you'll find a single termination of an agent or member of management for financing insurance outside of Cedar Rapids and a couple of other districts in the 80s.

The ex-employee felt not only that churning was condoned by management, but also that management explicitly allowed it. Many Prudential customers complained about their new life insurance policies before this scandal fully surfaced in 1994, and, according to this ex-employee, Prudential addressed such complaints in the following manner (Florida Department of Insurance 1996a, 35):

> **WITNESS:** ...whenever they [the customer] had a complaint, the first thing they had to do if they had an oral complaint, they had to put it in writing.

> That knocked down a number of the complaints right away because most of our customers, because most of their educational level and because of their financial circumstances, hesitated to put things in writing.
>
> The second thing we did is we would get the complaint and then would ask the agent what the agent did. If the agent said he did it right, we would deny the complaint and we would hold to that denial through three or four subsequent complaints. And basically we didn't actually do an investigation except to get the statement of the person who was complained about, and that was the position in Prudential probably until late 1994.

Some Prudential executives did seek changes, given the growing number of customer complaints (although it was later alleged that not all complaints were logged into the company's database). One such measure was having the customer sign a release verifying that he or she fully understood the terms and conditions of his or her new policy. Testimony recounts the reaction to such a measure (Florida Department of Insurance 1996a, 39):

> **WITNESS:** The next one is a memo [dated August 29, 1995] from Bill Hunt [head of Ordinary Agencies]: "I do not believe we should have the applicant sign off on anything. Not only does this imply a lack of trust toward agents, it also has the potential to build skepticism from the prospective insured regarding what they are being sold." Basically what he is saying is he is not going to ask him to sign anything because it could disrupt the sale.

The selling of life insurance has become a complex process. Clearly, customers frequently do not understand the product they are buying, but instead appear to place a high level of trust in their agent. That trust places additional burdens and responsibilities on agents and Prudential itself. It also appears evident that sales practices such as churning and refinancings were not only widespread but may have been occurring for an extended period of time. The witness implied that financial incentives may have encouraged this activity and that management's attitude toward controls and problems was questionable.

A New CEO

As early as 1982, the company's internal auditors reported to the Board of Directors fraudulent practices on the part of sales agents. In addition, internal audits of individual divisions and regional offices in the early 1990s detailed a failure by management to enforce consumer-protection laws and regulations. In a June 1994 report commissioned by Prudential in the wake of regulatory inquiries about insurance sales practices, Coopers & Lybrand stated that Prudential officials failed to act adequately upon such warnings. The Board admitted that it had been made aware of "major irregularities," but they continually asserted that they trusted management's claims that the problems were being properly monitored (Scism and Paltrow 1997).

In November 1994, Prudential's board turned to Arthur Ryan (the president of Chase Manhattan Corp.). This was the first time in over 120 years that Prudential had looked outside the company to fill the position of CEO. Lacking any formal background in the field of insurance, his reputation was built upon his ability to streamline operations and introduce new technology. He is renowned for rolling up his sleeves at his own computer. He enjoys working one-on-one, but is perfectly comfortable at center stage of the company auditorium (Treaster 1997). Simply put, Ryan is direct, open, focused, and engaged.

Ryan's Reaction and Changes

Ryan had made a conscious choice to change Prudential's business approach. Under Ryan's command, Prudential would no longer be a "series of independent silos, freewheeling subsidiaries working at cross-purposes with fragmented game plans" (Treaster 1997). The buzzword at Ryan's Prudential was "One Prudential" (Prudential 1996 Annual Report, 2). This "One Prudential" would be about facilitating teamwork and cooperation.

To break from the past, Ryan began recreating Prudential's management team. Much of the old guard was released. Twelve of the 14 executives who reported directly to the CEO were hired by Ryan. Of the top 150 executives, two-thirds were new, and half of these replacements were newcomers to Prudential.

Ryan also decided on cutbacks like those that had won him much praise at Chase Manhattan. Within two years of Ryan's arrival, a workforce of 100,000 had been reduced to 83,000 (Treaster 1997). Ryan also eliminated about $790 million in overhead (Scism 1997b) by shutting down five regional headquarters (that had once been proud outposts for the company's management). He also sold the home-mortgage operation, thereby reducing the company's exposure in the homeowner's insurance side of the business (Treaster 1997). By the end of 1995, Ryan's restructuring had resulted in seven major operating groups: individual insurance, money management, securities, healthcare, private asset management, international insurance, and a diversified group (Schwartz 1995, 26).

Although Ryan's actions would appear to be a step in the right direction, not all of his streamlining was met with open arms. The company's insurance sales force, which numbered 20,000 when Ryan came to Prudential, was cut in half within four years. The company fired or counseled out agents who could barely sell enough insurance to cover the costs of their employee benefits. During the first months of 1997, more than 1,600 junior and senior insurance-sales managers were still going through "very severe reviews." As a result, about 100 of these employees left Prudential.

Arthur Ryan's labor troubles did not end with complaints from the sales force over tighter controls. In an effort to mitigate some of the damage to Prudential's bottom line resulting from the churning scandal, Prudential attempted to increase agent production quotas. The proposed labor contract would have increased quotas by 25 percent, but the union representing Prudential's insurance agents rejected the deal (Scism 1997a).

In 1998, Prudential officials estimated that the class-action suit could cost Prudential as much as $2 billion. Many questions still remain for Arthur Ryan, but for the customers of Prudential Insurance Co. of America, the most significant question remaining is, "Has enough been done to ensure that they will not be the next Carol Nicholson?"

Discussion Questions

1. The Committee of Sponsoring Organizations (COSO) *Internal Control-Integrated Framework* document states that companies must set objectives in three areas: operations, financial reporting, and compliance. COSO further states

that to achieve those objectives, companies must have five components in place: control environment, risk assessment, control activities, information and communication, and monitoring. To what extent are the aspects in the case related to the COSO components and objectives?[2]

2. Read the risk framework suggested by the Special Committee on Assurance Services at the AICPA's web site (http://www.aicpa.org). If you were a business risk advisor to Prudential, what sales, marketing, and strategy risks could you identify for the period from the 1980s and the early 1990s, and how were the risks related to the company's problems seen in the case?
3. As their business risk advisor, assess the importance of the risks you identified in Question 2. First, consider whether the dollar significance for each risk is low, medium, or high. This dollar significance is not necessarily related to "audit materiality," but rather to what you would consider significant. Second, evaluate the likelihood of occurrence of each risk as low, medium, or high. Having evaluated each risk on the basis of *significance* and *likelihood*, consider how Prudential should factor in the costs vs. the benefits of any solutions to manage the risks.
4. Consider the risks you identified in Question 2. Has Prudential done enough to adequately manage these risks? Why or why not?
5. If you were engaged by Prudential to advise them, what are some possible business control solutions to the risks identified in Question 2? Consider controls to ensure that situations like the one experienced by the Nicholsons are eliminated or at least minimized.
6. What other industries/companies face problems similar to Prudential's "churning" of policies?

[2] In 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued a final report *Internal Controls-Integrated Framework*, which is a comprehensive way of looking at business controls. COSO set the standard for internal control. Using COSO's document as a guide, management can assess and report on their internal control. Additionally, professional auditing standards have adopted portions of the COSO document.

TEACHING NOTES

Teaching Objectives and Classroom Use

This case can be used to expose students to one of the emerging services identified by the AICPA's Special Committee on Assurance Services (AICPA 1997). The committee's report is available on the AICPA's web site at http://www.aicpa.org. The main objectives of the case are to have students learn how to identify business risks, assess business risks, and then build control solutions for those risks. Although several risks can be identified in the case, the control solutions focus on the risks in the sales/marketing function.

Additionally, this case can be used to apply the recently issued AICPA Statement of Position 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*. That statement addresses how CPAs can *attest* on an insurance company's sales practices. This use of the case would fit well into advanced auditing classes.

Instructors can also use the case to discuss how strategic business risks affect an audit of financial statements. The importance of cases that highlight business risks and audit approaches could be quite high given that CPA firms are changing (or have changed) their audit approaches to incorporate more strategic business issues and risks facing their clients. An auditor who has identified the risks in Question 2 should consider assessing inherent risks as medium or high and then focus his or her attention on the SAS No. 78 control components (control environment, risk assessment, control activities, information and communications, and monitoring). Specifically, an auditor analyzing a company's marketing activities and related risks should consider whether certain control activities are in place and functioning effectively to help the company manage its risk. Instructors could use the risks and related control activities to point out that if the control activities are not functioning as intended, then the auditor should consider raising control risk and possibly change the nature, timing, or extent of auditing procedures.

We have used this case three times in a business risk course that is part of our graduate accounting curriculum. The course focuses on the growing area of risk management and consulting. In that course, we cover the major areas of risk for a business and we use the case to focus specifically on sales/marketing risks. Others may choose to discuss these risks as part of an auditing, assurance, or consulting class. The students usually have little work experience (except for internships in public accounting) and have an undergraduate accounting degree. We assign the case reading and questions as homework. The students work on the case in case teams (usually 3–4 students). We also ask them to draft answers to the questions as a team. We discuss the case using a seminar-type approach. That is, there is no "presenting" during class; instead, we serve as discussion leaders and guide the discussion to ensure that the stated case objectives (listed above) are covered. The benefits of the case are that students learn these objectives, learn the objectives as they apply to a real situation, and learn a new area of assurance service (risk) at the same time.

We believe the case meets the educational objectives of learning risk identification, risk assessment, and building control solutions. From our experience with the case, the students gained insight into risks that are associated with sales and marketing areas. The class discussion was a valuable method for getting students to think and share about what the specific risks are in this area. The teaching note offers guidance on the sales/marketing risks that were identified. Once those specific risks are identified, the student learns how to add value to a business by seeing that risks must be assessed to know their significance. That is, students gain a sense of how important it is to assess the potential significance level of a risk. Further, the student learns how to identify specific control solutions to match those risks.

We spend one class period (75 minutes) on the case, although the case could be spread over two periods. We discuss how the case builds upon skills learned in auditing courses, and we also point out how the case leads to new services offered by CPAs. Specifically, we discuss the recently issued AICPA Statement of Position 98-6. We believe that Questions 1–4 can be covered in one day. However, two class periods may be required if the instructor wants to spend considerable time on building control solutions, discussing how the risks affect an audit approach, and discussing SOP 98-6.

Supplemental Materials

A 20-minute segment from *ABC News' Primetime Live* entitled "Rock in a Hard Place" that originally aired on December 11, 1996 can be purchased from ABC News[3] and used with the case. In the video, *Primetime* used hidden cameras to videotape sales tactics used by some employees. The video greatly enhances the case because it provides informative interviews with Prudential customers and employees, and serves as a powerful lead-in to any discussion on the practice of churning and/or Prudential's corporate culture.

In addition to the AICPA's risk framework, the students could refer to another framework for additional background. Two sources for this background are *Perspectives on Risk for Boards of Directors, Audit Committees, and Management* (Deloitte & Touche 1997), and *Managing Business Risks—An Integrated Approach* (Economist Intelligence Unit [1995] in cooperation with Arthur Andersen & Co.). The staff of the Economist and Arthur Andersen have teamed up to write two additional publications on business risk. The AICPA's web site describes risk services and also shows their risk framework (see Exhibit A). This web site also has some valuable links (for example, there is a link to a risk questionnaire). We have relied more on the frameworks than on the questionnaire. In addition to these, excellent readings on business risk include "Managing Risk" (*Business Week* 1994), "Redefining Risk" (Barr 1996), and *A Conceptual Framework for Integrated Risk Management* (Nottingham 1997). The COSO (1992) document *Internal Control—Integrated Framework* is also valuable for identifying risks and seeing the link between risks and control solutions.

Question 1—Business Objectives and Control Components

COSO states that companies must set objectives in each major area of their business, including operations, financial reporting, and compliance. COSO also notes that to achieve those objectives, companies must have five internal control components in place (control environment, risk assessment, control activities, information and communication, and monitoring). Consider, for example, how this relates to traditional accounting and the *financial-reporting objective*. To achieve its financial-reporting objectives, a company must have a good control environment

[3] Phone number is (800) 505-6139.

EXHIBIT A
Risk Framework

Strategic environment risks—threats from broad factors external to the business including changes in customers' tastes and preferences, creation of substitute products, or changes in the competitive environment, political arena, legal/regulatory rules, and capital availability.

Operating environment risks—threats from ineffective or inefficient business processes for acquiring, transforming, and marketing goods and services, as well as loss of physical, financial, information, intellectual, or market-based (such as customer base) assets, loss of markets or market opportunities, and loss of reputation.

Information risks—threats from the use of poor-quality information for operational, financial, or strategic decision making within the business and providing misleading information provided to outsiders.

Source: Special Committee on Assurance Services (http://www.aicpa.org).

and good control activities (as well as risk assessment, information and communication, and monitoring). To follow up on control activities traditionally meant adequate documents and records, segregation of duties, etc. These are still valuable pieces of control, but they relate primarily to the financial-reporting objectives. One of the advantages of this case is that it shows not only how accountants can work in traditional areas, but also how they can help with the *operational objectives* area.

Again using COSO's components as a guide, the instructor could lead the students in a discussion (similar to the above) focused on *financial-reporting objectives* and the five components. Next, the instructor could turn to *operational objectives* and the five components. For example, the discussion could focus on how Prudential's control environment influenced its objectives, or what control activities could help Prudential meet its objectives (the answer to this is pursued in detail in Question 5). Finally, students could be asked to consider how risk assessment relates to these objectives. The key point here is to get students to see that COSO components are a valuable way to examine a business and that risk is an important part of that evaluation. This is merely a precursor and leads directly to Question 2.

Question 2—The Role of Risk

This question helps students learn to identify risks, educates them on the various types of risks, and offers them the opportunity to think beyond their traditional accounting courses. One risk to discuss is associated with Prudential's *marketing activities*. This risk is not the traditional revenue-cycle control approach found in auditing textbooks, but instead is the risk associated with the marketing activities of Prudential.[4] As indicated by the ex-employee's testimony, the customer is at the agent's mercy. The customer blindly signs multiple forms, trusting the agent's judgment and character. To complicate matters, in an insurance organization as large as Prudential, agents often find themselves operating their

[4] The COSO document lists many additional risks and controls of the marketing module.

own business. Local branches have their own clients and often their own subculture. Corporate management's efforts to monitor the activities in these branches can be difficult.

For Prudential, an out-of-control sales and marketing process created considerable risk. Such risks include: the risk associated with selling a complex product; the risk of the company's marketing strategies not being followed by the marketing and sales groups; the risk that the company's marketing strategy does not meet the markets needs; the risks associated with promotion brochures; the risk that a product has become obsolete; and the risk that incentive and bonus systems are misaligned with the customers' needs. Incentive systems themselves may create risk. Companies should know the consequences of such systems and should also consider how they affect their customers. Failure to pay attention to risks can not only lead to lawsuits (somewhat obvious from the case), but can also lead to poor profitability (although Prudential was profitable during the 1980s). Poor profitability can occur because the company is missing its target markets, does not understand its market, and is mispricing products.

Because marketing and sales risks are so crucial to this case, we usually try to summarize and present on the board a list of such risks. A list might include:

(1) the risk that marketing plans do not support corporate strategies;
(2) the risk that corporate strategies do not comprehend customer needs;
(3) the risk that corporate strategies in this area do not address the current and future business environment;
(4) the risk that the company will lose customers because their needs were not met;
(5) the risk of excessive pressure on agents to sell unwanted/unneeded products to customers;
(6) the risk of poor behavior created from incentive and bonus systems;
(7) the risk of agents acting outside of or not knowing company policy;
(8) the risk of customers misunderstanding their new policy; and
(9) the risk of agents misleading customers.

The inability of Prudential's management to monitor its agents indicates a second key risk—*corporate culture risk*. The corporate culture is an integral aspect of an entity's control environment, and in its assessment of Prudential's control environment, Coopers & Lybrand (1994, 2) defined a corporate culture:

> Culture incorporates many elements, most importantly the values and beliefs of the people who comprise the company. It is primarily driven by the actions and examples of key leaders, by the corporate value statements that people believe in and strive to uphold, the organization and infrastructure in place to support their activities, and compensation plans that encourage specific action, among other factors.

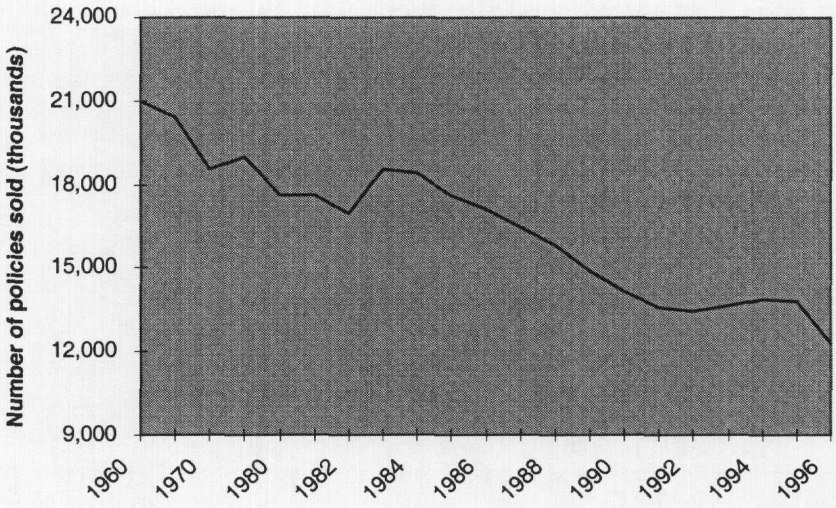
The testimony of the ex-employee serves as the richest source of evidence on this subject. According to this witness, top management did nothing to stop the refinancing of insurance policies, even though it probably was aware of such improprieties. As a training video from the *Primetime Live* segment indicates, Prudential executives apparently believed that the ends justified the means. In short, the Prudential culture stressed new sales.

This philosophy was imbedded in an agent's incentive plan. New sales translated into money for everyone—agents and managers benefited. Hence, the more agents sold, the higher their pay. Such a philosophy inevitably led to some suspicious sales. Some questionable sales could probably also be attributed to the quota system that management had initiated. Management ensured that quotas were a part of the agents' labor agreement, further heightening the pressure to sell new life insurance policies. It is also very likely that the stringent agent reviews and reduction in the size of the workforce increased the pressure on the sales staff, although this appears to have taken place after Ryan came on board.

Prudential's executives had additional policies and practices that fostered churning. It was alleged in the Parsons and Engdale (1995) investigative memorandum that customer complaints were almost ignored and that agents were never punished for their inappropriate actions. Specifically, that document alleges that one of the reasons the problem was not detected earlier is that customer complaints were somehow not being "logged into the Company's complaint database." One employee suggested that the reason the complaints were not logged in was that the vice president was already aware of them. The corporate culture at Prudential appears to have been weak.

How could such practices continue in Prudential for so long and at such magnitude? One answer to this question could lie in Prudential's inability to manage a third key risk—*strategic risk*. The company continued to push life insurance policies even when the market was not demanding this commodity (see Exhibit 4). In fact, Exhibits 3 and 4 show that sales were not climbing as fast as they had been and that the overall number of policies was declining. These numbers suggest even greater pressure on the sales force and perhaps exacerbate the risk associated with marketing activities mentioned above. The life insurance industry had seen significant changes over the past 10–15 years. Increasingly more prospective policyholders simply did not want to sit around a kitchen table with an insurance agent to discuss buying a pricey whole-life policy. Exhibit B helps instructors to further illustrate this point.

EXHIBIT B
Industry-Wide Sales of Individual Life Insurance Policies



Source: Columns 1 and 2 from Exhibit 4.

Management failed to properly research the market, or it just ignored its own findings. Life insurance was not a growth product, but a declining product. Placing so much emphasis in such a product was a risky management decision, and hindsight illuminates the repercussions of this decision. Management clearly should have understood key market trends and considered the impact of those trends on the company.

Another possible risk is Prudential's *form of corporate governance*. Some of the root causes discussed previously may have been aggravated because Prudential is a mutual company. The owners of the company—the policyholders—may be somewhat uninterested (or at least not as interested as stockholders in a public company). Prudential had 24 board members throughout this time period. In today's business climate, many corporations are moving toward smaller boards because they believe that smaller boards are more effective than larger ones. Additional research by the students would show that some board members served on numerous corporate boards. One board member was a member of ten other boards. Board positions should be demanding, and it is difficult to expect that an individual can properly serve multiple entities in such a capacity.

The risk frameworks mentioned previously (e.g., Exhibit A) are helpful in facilitating risk identification at Prudential. The lesson here is that the students need a way to learn to identify risks. If the students did not identify all the risks mentioned above, we usually ask them to refer back to the risk frameworks to see what risks may apply. Most students like using the frameworks as a method to identify risks. Additionally, the AICPA's web site has a risk identification questionnaire available that can be used to promote discussion of possible risks. The questionnaire lists questions that advisors should ask their clients. Examples include "Does the company receive recurring customer complaints?" and "Are there potential changes to customers' businesses or needs that might reduce or eliminate their need for the company's product?" The risk framework and questionnaire can be handed out at the same time the case is assigned.

Students can use this questionnaire as a guide when attempting to identify risks for Prudential. It is important for them to see the connection between the risks and the eventual problems. Knowing a company's risks and then developing solutions to control those risks is a key value-added activity for any consultant and is a primary purpose of the case.

Question 3—Risk Assessment

After students have identified key risks, they must consider the effect of the risks on the company. Exhibit C is a guide to facilitate this discussion. Students can be asked to classify the risks using the exhibit. Understanding the effect of risks will influence the control solution. Each specific risk must be assessed as to its dollar effect and its likelihood of occurrence. Risks that could have high dollar effect and a high chance of occurring (quadrant one in the exhibit) should be controlled differently than low dollar and low likelihood risks (quadrant four). For example, where risk is low, the company may choose to monitor only periodically and monitor only after the event occurs. In contrast, high-risk events must be controlled more frequently and possibly prevented at the source (rather than being detected only after the event occurs). The frequency of monitoring will vary with the risk.

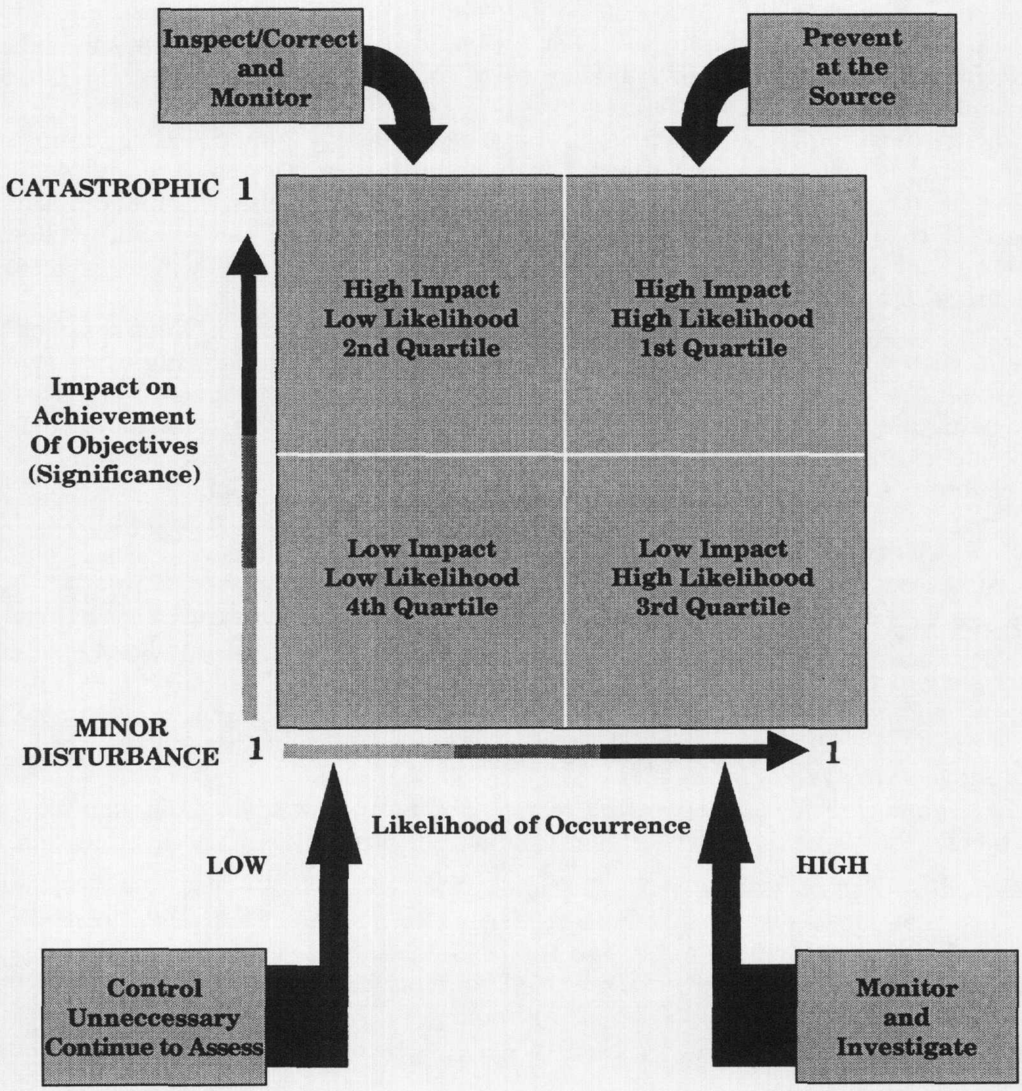
While working through the dollar effect and likelihood, the issue may arise as to how to know the true effect and likelihood. Clearly, each company must make its own decisions, and a full discussion is beyond the scope of this case. However, the answer depends on the risk itself and the amount of data available. Like companies, students will need to make a choice about the level of risk. Some companies find that strategic issues cannot be quantified exactly but that they just "know" or have "intuition" that the risk is medium or high. In these cases, companies could still benchmark against other companies that have faced similar issues and then decide if their assessment of risk is reasonable. For risks that are quantifiable, companies may choose to benchmark; alternatively, some companies are developing event-history analysis tools so they can quantify the actual dollar effect and likelihood.

The third part of this question guides the students to consider costs vs. benefits of building controls to manage risks. After students have a sense of the dollar effect and likelihood, they may be ready to design controls and solutions. However, they should always remember the importance of balancing the costs and benefits of any solutions. If the risk is very high, then Prudential could have a second person interview every single customer. However, this is a costly solution and Prudential must weigh that cost against the risk (Question 5 addresses solutions in more detail). Many companies have leaned toward a perspective that suggests controls are costly and hinder business. This is a negative view of controls. For Prudential, having fewer controls may have led to greater sales and revenues in the short run, but, in the long run, perhaps it was a key cause of the billions of dollars they were assessed by the courts. A few more controls and a better assessment of risks may have helped them avoid these problems in the first place.

Question 4—Prudential's Changes: Has Enough Been Done?

This question is asked so that students think through Prudential's changes. It leads into Question 5 on possible additional changes that are needed. It is

EXHIBIT C
Risk Management
Addressing Impact and Liklihood of Occurrence



Adapted from: The Economist Intelligence Unit (1995, 3) and Deloitte & Touche LLP (1997, 13).

important for the instructor to first point out the risks and problems in Questions 1–3, and use this question to determine whether all problems are under control. It will become obvious that further solutions are necessary—which leads to Question 5. It may be helpful if the instructor classifies all changes according to the risk previously identified. Taking this approach helps students see how understanding risks leads to certain actions and controls.

Ryan had no experience in the insurance field. However, he did have significant experience at Chase Manhattan that would be useful at Prudential. His banking background sends a potential message of Prudential's new focus—a message that is needed given their strategic risks.

Ryan also brought with him a reputation for trimming the fat and streamlining operations. Prudential had a reputation for "recruiting heavy" and "managing light." The case indicates that many employees did not produce enough revenues to merit their employment benefits, and with the life insurance market in decline, Prudential probably did not need as many agents in the field. This move also appears related to strategic risks.

Ryan's most impressive move might have been his realignment of Prudential's top executives. The old brass appears to have been dismissed, and many of the replacement executives were new to the firm. Prudential definitely made a conscious effort to make changes in its hiring qualifications. The new executives had banking and investment backgrounds, and these credentials sent a message to Prudential employees as to the company's focus.

The realignment of Prudential's focus was another key change. Given his background with Chase Manhattan, Ryan knew the importance of offering attractive investment products for retirement investors. In addition, without so much pressure being placed on the insurance division, the likelihood of misrepresentations to policyholders was probably diminished. As predicted, Ryan also streamlined the company's operations to create a more centralized Prudential.

The CEO's moves to ensure better job performance should also be highlighted. Many Prudential agents are being subjected to strict evaluations well into Ryan's tenure. As outlined in the case, 1,600 agents and managers went through "severe" reviews in 1997. It is important that these reviews were continuing three years after Ryan arrived. In addition, the fact that many of these employees were being sent to training classes is an impressive step in the right direction. This training should have highlighted areas of concern and addressed proper procedures to avoid unethical actions. The instructor could spend time on the appropriate incentive system for agents.

In summary, a new focus with new executives and new training is emerging. But has enough been done? The students should be challenged with this question.

Question 5—Business Control Solutions

This question is designed to help students think about the kinds of controls that should be established to manage the risks faced by Prudential. Again, note that these are not the traditional internal controls but rather are control solutions that are needed to help Prudential manage its risk and ultimately achieve its objectives.[5] This case can be used to address primarily the controls for the

[5] The business control solutions that follow are not necessarily the controls implemented at Prudential. Instead, they represent an eclectic approach to the risks faced.

sales / marketing process risks rather than to emphasize controls for *strategic risks*. However, sufficient material is available to take a strategic risk and controls approach. When discussing these controls, their role should be placed in perspective. Prudential must first adequately address its control environment and strategic risks. If they fail to have an adequate corporate environment, or they fail to understand the strategic risks facing their company, then controlling the sales/marketing process risks will have less effect overall.

It is helpful if the instructor spends some time reviewing the specific sales/ marketing risks in this process. The instructor can take the time to discuss the effect (dollar and likelihood) of each risk, although at this point the students may already sense the importance. However, students should always be challenged to weigh the cost of their solutions against the risks and benefits.

One can take the view that sales/marketing risks are simply an agency problem. Just *hire* the right people and this will take care of itself. However, the risks are so high that more is needed than simply choosing the best sales people. One control is a stringent *review* process, which agents and managers are now undergoing. As can be seen from the case, Prudential is hiring selectively and doing more intensive performance reviews. However, even this is not enough when the impact from the risk is so high. For example, what can you learn about the customer's needs and understanding of the product by weeding out poor-performing sales people? The answer is very little, unless performance includes information on the customer.

One additional business control solution to help monitor sales/marketing risk is to *interview customers* after each sale. This could be done by phone. The extent of using this control would depend on the assessment of risk. The instructor may want to ask the class which customers should be interviewed. Clearly, refinancings are the main problem right now. Therefore, refinancings should be targeted, and perhaps other types of policies as well. Some students may suggest interviewing customers with non-refinanced policies to make sure no major problems in this area are currently hidden. Because interviewing customers is a costly process, the students should be challenged to consider the benefits vs. the costs (recall that the lawsuits have cost Prudential billions of dollars). The instructor may also choose to spend time discussing what information would be asked of customers and who would ask the customers (this second part will come up again later).

In addition to capturing a customer's understanding of a transaction, customer interviews could also be very useful in measuring customer satisfaction. Many companies today do not capture customer satisfaction of their products. However, some major hotel chains now capture such information as the customer checks out. Timely information on customers' satisfaction or dissatisfaction can be very valuable and might even be a necessity in some industries. The risk framework developed by The Economist study (Economist Intelligence Unit [1995] in cooperation with Arthur Andersen & Co.) details the story of one company that decided customer satisfaction is a critical risk to be managed and controlled. The instructor could spend considerable time developing this line of thought.

The discussion should include some focus on the role of the information system. How will management know if churning is occurring? Prudential's *information system* is a key component in this process. It must be able to flag replacement policies so that the company can contact these customers. To properly manage risky policies, management must identify risk events and capture that information within the company's information system. For example, management may choose to code any refinanced policies so that they can be identified and tracked. Management may choose to monitor (via information capture) the number of refinancings by region, office, and by employee. As noted previously, management could also choose to capture customer satisfaction information. One key point here is that the system must capture more than the fact that a sale occurred.

To more closely control the risk on whether the customer understands the transactions, information systems can be developed that document the customer's understanding and knowledge *as the sale is occurring*. Recent *programming innovations* have allowed agents the opportunity to truly match a customer's purchases with his or her needs. By answering a series of questions about income, risk preferences, and investment goals, software packages provide the optimal insurance and investing options for that customer. By creating needs-based sales, a portion of Prudential's risk can be mitigated. If done, then a copy of the client's results should be kept in his or her file. This business control allows Prudential the ability to limit the sales/marketing risk *before* the sale happens, whereas interviewing customers can only control risk *after* the sale. Considerable debate may exist on which of these solutions is best. Prudential must choose the appropriate answer based on a risk analysis. Clearly, both solutions are costly.

Another possible solution is a separate *compliance unit*. Such a unit could make periodic reviews of customer files to ensure procedures are being followed. In 1996, State Farm Insurance Company created a separate compliance unit to ensure that the company stayed on top of the ethical issues within the industry. If Prudential has not done so already, then it should follow suit. This compliance unit should be an offshoot of the internal audit function and should be independent of the marketing segment so that it is as bias-free as possible.

A better solution would be a *compliance unit run by a third party* (given the unheard cries of Prudential's internal audit department during the churning scam). Some insurance companies have adopted a pair of such programs. The Life Insurance Marketing Research Association Customer Assurance Program (LIMRA CAP) provides a method for verifying a customer's understanding of product purchases and transactions entered. LIMRA CAP allows direct contact with a recent life insurance or annuity buyer through a *questionnaire* created by the insurance company, which is then mailed to LIMRA CAP. Results of the questionnaires are tallied by LIMRA CAP and reported to the insurer.

A second program designed to control risk is sponsored by the Insurance Marketplace Standards Association (IMSA). Exhibit D details the purpose of IMSA. As noted in the exhibit, IMSA came into being because of widespread scandals in the life insurance industry. As further noted in the exhibit, auditors can play a role in performing these *independent assessments of the sales/marketing process*. Statement of Position 98-6 (AICPA 1998) was recently issued to offer guidance to accountants in performing these services. Such services are a new and growing area for accountants, and the instructor could spend considerable time going through the new statement and how it applies in this case. Note that the standards in Exhibit D include "fair and expeditious handling of customer complaints and disputes." The witness implied earlier that Prudential did poorly in this area. An assessor of this area should be able to determine how well a company handles customer complaints.

EXHIBIT D
IMSA Standards[a]

With the image of the life insurance industry tarnished after a series of well-publicized investigations and class-action lawsuits over sales tactics, the American Council of Life Insurance sponsored the creation of the Insurance Marketplace Standards Association (IMSA). The IMSA is intended to provide a more stringent set of ethical principles. The IMSA's "Principles of Ethical Market Conduct" include:

- To conduct business according to high standards of honesty and fairness and to render those services to its customers which, in the same circumstances, it would apply to or demand for itself.
- To provide competent and customer-focused sales and service.
- To engage in active and fair competition.
- To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.
- To provide for fair and expeditious handling of customer complaints and disputes.
- To maintain a system of supervision and review that is designed to achieve compliance with the Principles of Ethical Market Conduct.

Insurance companies can become members of the IMSA by completing a self-assessment, followed by an additional assessment made by a certified independent assessor. In these assessments, insurance companies must prove that they adhere to strict IMSA standards by answering 162 rigorous questions. Independent assessments can be done by a qualified assessor who has significant industry knowledge. Independent assessors include accountants, lawyers, and consultants, and this assessment can cost a company anywhere from $10,000 to $250,000. The self-evaluation is often more expensive. Re-certification occurs every three years.
The Prudential Insurance Co. of America was one of 155 IMSA members as of April 1, 1998.

[a] Source: AICPA (1998).

Other control issues can be discussed if time allows. For example, the instructor can spend time on controls related to marketing brochures. The case indicated that unauthorized material was being used in sales presentations. Additionally, the discussion can revolve around how the company would control the practices taught at the sales training meetings. Recall that some of the questionable sales practices were being taught by sales agents to other agents.

Before concluding the discussion on possible control solutions, it should be noted that this case is an example of how much poor risk management can cost a company. Between its poor operating environment and its inability to move with a changing market, Prudential incurred losses of billions of dollars. In the end, Prudential is making the changes it should have made five to ten years earlier. Unfortunately for Prudential, revenues will probably suffer as the company attempts to catch up with its competitors, and the settlement of the class-action lawsuit will affect the bottom line. Finally, the issue of Prudential's reputation is important. For years this company built its reputation of trust upon the Rock of Gibraltar. This reputation has no doubt been tarnished and is in need of repair. Questions remain as to how long this process will take, and how much it will cost.

In closing the discussion of this case, an observation to make is that, in recovering from this scandal, Prudential cannot just look at correcting the past. It must look to the future. Identifying business risks and setting proper controls is a forward-looking practice. Risks must be identified and assessed on a continual basis. Control solutions must be designed to manage the identified risks. Addressing future concerns before they become problems is just as important as correcting past difficulties.

Question 6—What Other Industries/Products Could Have Similar Risks?

To introduce this section, the instructor may want to point out that several insurance companies have gotten into trouble in this area (including such companies as Metropolitan Life Insurance and State Farm Insurance), which leads to this question: What other industries or products have similar risks? This question asks students to think beyond life insurance. An example that some students may identify is the risk caused by the behavior of IRS agents (who have received much negative publicity for their tactics). Others may suggest that nursing home insurance policies and annuity contracts (same industry but different product) are equally at risk because they are a complex product in which the customers must rely on the agent. Some will even suggest that public accounting firms are at considerable risk because reliance is placed on what staff auditors report they did while with the client. This risk exists because no one really sees the staff auditor perform certain tasks, and the incentive exists to sign off on audit steps to look efficient. Another example may be the Sears debacle of the early 1990s in which Sears automotive managers were pushing unneeded repairs on customers. In that case, it was in the economic interest of Sears' managers to increase sales even though it was not in the best interest of customers (see Patterson 1992).

The example we discuss is the long-distance phone business and "slamming." Slamming occurs when a customer's long-distance carrier is switched without the customer's knowledge or approval. Most major phone providers have been accused of slamming, and the problem is growing. Numerous articles were written documenting the issue (see Keller 1998a, 1998b). The risk is similar to life insurance sales. Increasing competition has put considerable pressure on the behavior of sales employees. Additionally, the risk is heightened with some long-distance carriers because they outsourced the marketing of their long-distance marketing. Solutions offered to correct slamming look similar to the solutions above. One is to have a supervisor call the customer to verify that the customer knows and has agreed to the change in service. A second solution is to have an independent company verify the change.

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