The Lehman Brothers Case

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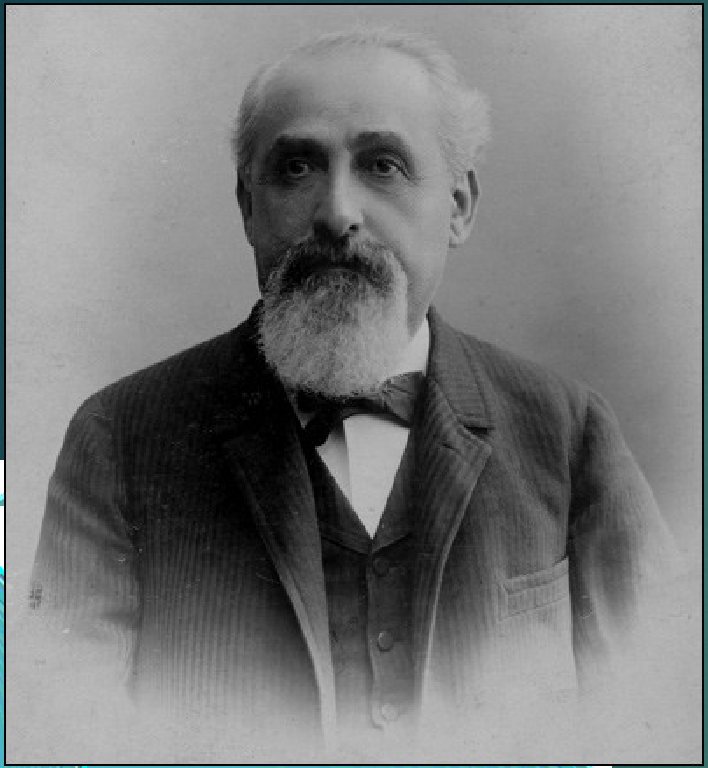
The Cotton Kings

→ 1844 - Henry Lehman, an immigrant from Germany opened a small dry good store in Alabama.
→ 1850 - Henry [illegible]d by brothers Emanuel and Mayer - they named the business Le[illegible]n Brothers.
→ Brothers became cotton merchants.
→ 1858 - they opened the office near to Wall Street financial district.
→ 1861 - Brothers closed their office.
→ 1861-1865 - American Civil War.
→ 1865 - Brothers established the New York Cotton Exchange.
→ 1887 → Lehman Brothers became members of the New York Stock Exchange



Emanuel Lehman joined his brothers Henry and Mayer as a clerk, and their little store was renamed Lehm Brothers. He arrived i America in 18

In 1850, Mayer Lehman joined his brother Henry in Montgomery, Alabama, to become a partner in Lehman Brothers.

The Second Generation

→ Focused on the investment banking industry.
→ 1929 - The Lehman Corporation is created - a closed-end investment company.
→ Lehman Brothers became major players in financial derivative markets that emerged in the final decade of the twentieth century.
→ Mid-1990 - new genre of exotic financial derivatives became increasingly more prevalent; these new derivatives collateralized debt obligations, credit default swaps, and interest rate swaps, among many others.

Playing with fire…

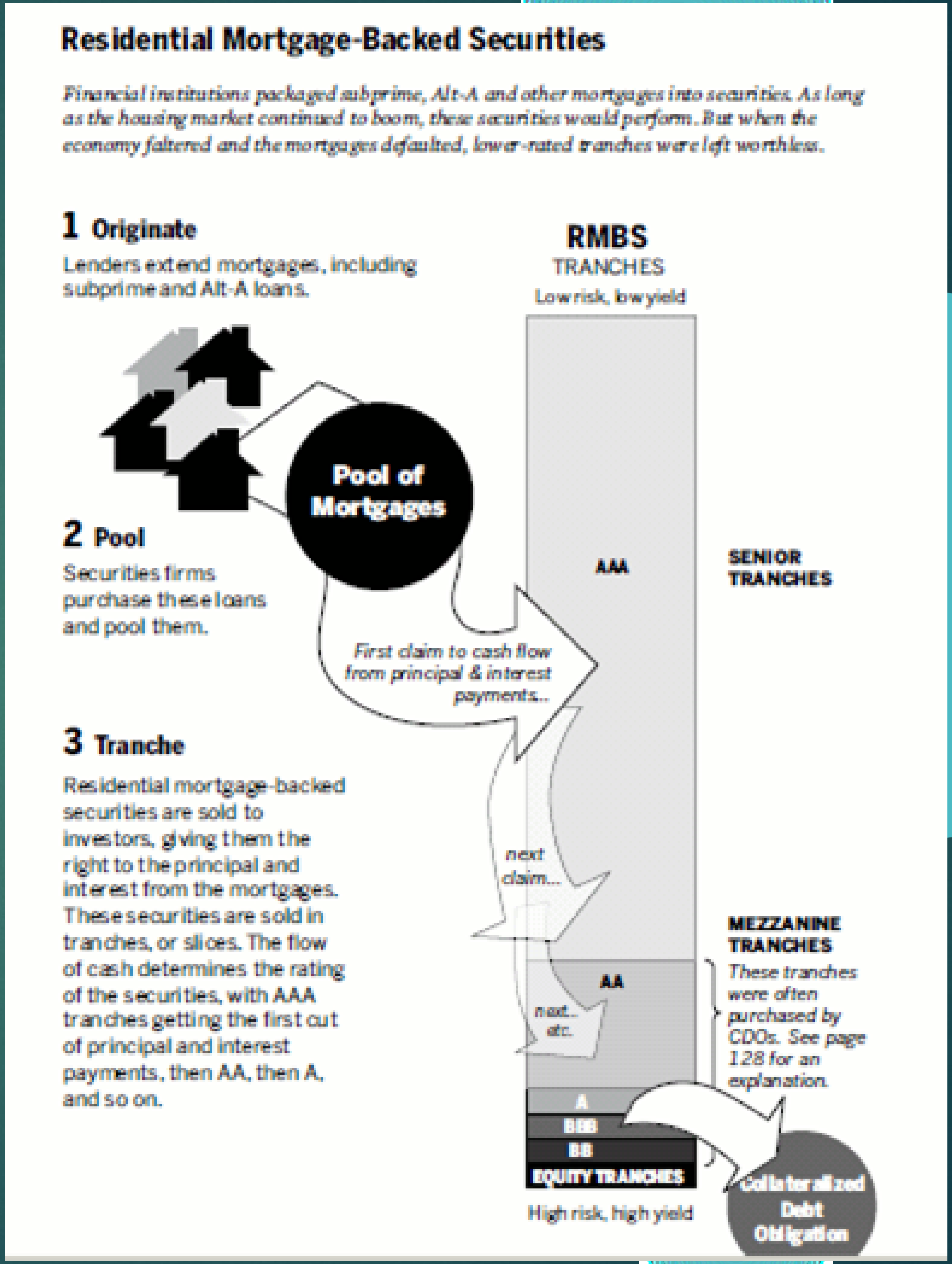
- The Lehman Brothers Company was a major player in the financial derivatives market.
  - A derivative [illegible] with a price that is dependent upon or derived from one or more underlying [illegible] he derivative itself is a contract between two or more parties based upon the a[illegible] assets. Its value is determined by fluctuations in the underlying asset. The most com[illegible] underlying assets include stocks, bonds, commodities, currencies, interest ra[illegible] and market indexes.
    Ref: http://www.investopedia.com/terms/d/derivative.asp
- Lehman Brothers was "particularly active in the market for RMBS"
  - A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages
    Ref: http://www.investopedia.com/terms/m/mbs.asp
- Behaviour : Transfe[illegible] the risks

Playing with fire...

→ By 2005 LB produced more RMBS annually than any other entity.
→ Housing prices peaked in the US in 2006, but by late 2007 had begun to tumble, declining in many residential markets by 20% or more by mid-200[illegible] [illegible]f the residential markets that had seen the [illegible]arpest increas[illegible] [illegible]r the previous years, such Las Vegas and south F[illegible]rida, housing pric[illegible] plunged by 50%.
→ By 2008 early 9 mi[illegible]on Americans had a negative equity in their homes, which caused a rapid rise in mortgage defaults and fo[illegible]eclosures.
[illegible] At the end of 2007, LB owned nearly 90 billion of toxic assets. By [illegible]mparison, LB's total stockholders equity at that time was only 22.5 billion.

→ Securisation process involved purchasing residential mortgages from banks, mortgage companies, and other entities that originated them, bundling or "pooling" these mortgages together and then selling ownership interests (securities) in these pools. The purc[illegible] f the RMBS were actual[illegible] purchasing a claim o[illegible] he cash flows generated [illegible]y the mortgages that "backed" those securities.

→ S[illegible]bprime is a classification for [illegible]rowers with a tarnished or limited credit history. Subprime loans carry more cred[illegible] risk, and as such, will carr[illegible] higher interest rates as we[illegible]



And yet, LB was apparently having strong results…

EXHIBIT 1

LEHMAN BROTHERS FINANCIAL HIGHLIGHTS, 2003–2007*

	2007	2006	2005	2004	2003
Revenues	$ 19.3	$ 17.6	$ 14.6	$ 11.6	$ 8.7
Net Income	4.2	4.0	3.3	2.4	1.7
Total Assets	691.1	503.6	410.1	357.2	312.1
Total Stockholders' Equity	22.5	19.2	16.8	14.9	13.2
Earnings per Share	7.26	6.81	5.43	3.95	3.17
Dividends per Share	.60	.48	.40	.32	.24
Year-end Stock Price	62.63	73.67	63.00	41.89	36.11
Return on Equity	20.8%	23.4%	21.6%	17.9%	18.2%
Leverage Ratio	30.7	26.2	24.4	23.9	23.7
Net Leverage Ratio	16.1	14.5	13.6	13.9	15.3

*In billions of dollars except for per share amounts.

Auditing Cases, Internati on, 9th Edition.
Extract from the cours ndra Lemeshko : Auditing MPF_AAUD

PROBLEM :

- The firm was « overleveraged »

- MEANING :
  Overleveraged is whe[illegible] business is carrying too much deb[illegible]nd is unable to pay interest payment[illegible]rom loans. Overleveraged compani[illegible]s are unable to pay their expenses be[illegible]ause of over excessive costs.

  Ref:
  http://www.investopedia.com/terms/o/overleveraged.asp#[illegible]uwLFvgnu

SOLUTION

- « Deleveraging strategy »

- HOW ?
  Accounting-motivated transactions

- NAME : Repo 105

Repo Central :

SFAS No.140

Financing transactions

Sales of securities

Unusual conditions are met

Auditors on the firing line

http://thetravellingsquid.com/2014/02/23/seven-great-reasons-to-travel-with-an-auditor/ernst-and-young-building/

→ E&Y were has been Lehman’s independent audit firm from 1994 to 2008, with the final audit before the bankruptcy filing being for fiscal 2007.

→ Bankruptcy ex[illegible]ner pointed out the audit firm as a guilty of professional malp[illegible]ctice which caused the losses to stakeholders

"Window-dressing" is the accounting technique used to temporarily enhance the appearance of a company's balance sheet for creditors and investors [illegible]thout perman[illegible]nging the true amount of asset and liability balances. [illegible] not always illega[illegible]audulent.

Main charges against E&Y

“Failure to conduct adequate inquiry” into the whistleblower’s allegations and “failing to properly inform management and the audit comm

Failure to “take pro r action” to investigate whether Lehman’s financial statemen for the first two quarters of 2008 were materially misleading due to t e company’s failure to disclose its Repo 105 transactions.

tracts from the bankruptcy report

"If auditors issue opinions that are unreliable or provide [illegible] for their clients by helping to hide [illegible]aterial info[illegible]tion, that harms the investing p[illegible]ublic, our eco[illegible]omy, and our country,"

Eric Schneiderman, New York attorney-general

Q1

When Lehman was developing its Repo 105 accounting policy, did E&Y have a responsibility to be involved in that process?

[illegible]hat role should [illegible]dit firm have when a client develops an in[illegible]portant new acc[illegible]ting policy?

A1

- E&Y was not directly involved in the process but auditors were aware about the Repo 105. They didn't formally approve it, but they didn't formally reje
  - > Professional re sibility
- PCAOB AU Section 0.02 : "The auditor has a responsibility to plan and perform the audit to obtain reasonabl ssurance about whether the FS are free of material misstatements, whether caused by error or aud"
- Important role on the confidence in the economy. They don't work only for one company, and it is not the purpose of the profession to let their clients wheel and deal with the gap of the law.
- art of ethic

Q2, Q3

Do you agree with the assertion that "intent doesn't matter" when applying accounting rules? That is, should reporting entities be allowed to apply accounting rules or approved exceptions to accounting rules for the express purpose of intentionally embellishing their financial statements or related financial data?

Do auditors have a responsibility to determine whether the transactions of a client are "accounting-motivated"?

A2, A3

→ Audit risk - Materiality

If window dressing in fact has a material effect on the firm financial health, it should be disclosed in the financial statements. Failure to disclose the effect of the window dressing is then a violation of the accounting framework. Failure to disclose was in fact misleading the investors to believe that Lehman finan[illegible]th was good when it was not.

→ Understanding ([illegible] entity and its environment)

Ernst and Young nee[illegible] to identify and focus on areas that posed the highest risk. The Repo "105" transactions posed significant risks since recognition of these transactions had direct impact on Lehman leverage ratio.

→ ISA 315

[illegible]n external auditors are obligated to evaluate business entities and provide a reasonable assurance that the financial statements are a true reflection of the entities' financial health and that the statements are compliant with the appropriate financial reporting framework i.e. US (GAAP)/IFRS

Q4

Do you believe that Schlich or one of his subordinates should have reviewed that letter? Why or why not? In general, how should the responsibili[illegible]erent facets of a multinational audit be allocated betw[illegible]or among the individual practice offices involved in the e[illegible]agement?

A4

Schlich or one of his subordinates should have reviewed the letter from the British law firm, as no law firm in the United States would review Lehman's Repo 105 a[illegible] policy, which should have caused concern for E&Y that something [illegible]e Repo 105 policy would be subject to legal issues. Any time a comp[illegible]ransfers assets to one of its international divisions, the independent audit [illegible]n should review both sides of the asset transfer, and maybe even use it own international divisions who are more familiar with the foreign regulations to input various opinions.

The auditing standard AU 336 provides guidelines on when to rely on the work of an expert. In addition, the auditor is required to exercise professional skepticism and judgment when deciding to what extent he or she will rely on the work of an expert.

Q5

What responsibility, if any, do auditors have to assess the material accuracy of financial data included in those two sections of a client's annual report?

At this era, the NLR didn't have to be included in the company's audited financial statement and it was not a "GAAP financial measure subject to being audit" (extract from the case).

But : Auditors have to identify the risks that are pervasive (= potential impact on a large number of items in the FS). Have to identify the risks that could result in a material misstatement of the financial statement.

Here : huge materiality

A5

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Summary - E&Y did not suffer the consequences

Auditors are not responsible of detecting fraud or unintentional material misstatements as they … audit risk of the … acceptance/ rejection th… materiality and sampling methodology. What they provide is simply reasonable (not absolute) assurance. The most telling assertion in the complaint concerning E&Y's suppose… misrepresentation of Lehm… compliance with applicable accounting standards is that E&Y didn't require the financial statements to reflect economic substance rather than just le… form.