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CASE 1.4

Lehman Brothers Holdings, Inc.

Debt is a prolific mother of folly and crime.

Benjamin Disraeli

Thursday, October 24, 1929, easily ranks as the most dramatic day that Wall Street has ever seen.[1] That day witnessed the beginning of the Great Stock Market Crash that over the following few years would result in an almost ninety percent decline in the Dow Jones Industrial Average (DJIA). Although not nearly as dramatic as "Black Thursday," September 15, 2008, is a date that modern day Wall Street insiders will not soon forget. On that day, one of Wall Street's iconic investment banking firms, Lehman Brothers, filed for bankruptcy. That bankruptcy filing ended the proud history of a firm that had played a major role in shaping the nation's securities markets and economy for more than a century.

Lehman Brothers had approximately $700 billion in assets when it failed, which makes it the largest corporate bankruptcy in U.S. history, easily surpassing the previous headline-grabbing bankruptcies of Enron, General Motors, and WorldCom. By comparison, the telecommunications giant WorldCom, which temporarily held the title of the nation's largest business failure after collapsing in 2002, had less than one-sixth the total assets claimed by Lehman Brothers.

The shocking announcement that Lehman had filed for bankruptcy caused the DJIA to plunge more than 500 points within a few hours. That large loss was only a harbinger of things to come. Within six months, the DJIA had declined by more than 50 percent from its all-time high of 14,164.53 that it had reached on October 9, 2007. That market decline wiped out nearly ten *trillion* dollars of "paper" wealth for stock market investors and plunged the U.S. and world economies into what became known as the Great Recession.

In the spring of 2010, the Lehman bankruptcy once again captured the nation's attention when the company's court-appointed bankruptcy examiner released his 2200-page report. In preparing the highly anticipated report, the bankruptcy examiner and his staff reviewed 20 million documents and 10 million e-mails and spent $38 million. The massive report documented the circumstances and events that had contributed to Lehman's collapse and the parties that the bankruptcy examiner believed could be held civilly liable for it.

The release of the bankruptcy report prompted a public outcry because it revealed that Lehman's executives had routinely used multi-billion dollar "accounting-motivated" transactions to embellish their company's financial data. Allegedly, those transactions had been executed for the express purpose of enhancing a financial ratio that regulatory authorities, stock market analysts, and investors considered to be a key indicator of the company's overall financial condition.

As the company's financial health was rapidly deteriorating in 2007 and 2008, Lehman's executives had ramped up their use of the controversial transactions, resulting in the company's liabilities being understated by as much as $50 billion. Arguably most shocking was that Lehman never disclosed or referred to those transactions in the 10-K and 10-Q registration statements it filed periodically with the Securities and Exchange Commission (SEC).

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1. I would like to thank Glen McLaughlin for his generous and continuing support of efforts to integrate ethics into business curricula. I would also like to thank T.J. Gillette for his excellent research that was instrumental in the development of this case.

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Another revelation in the bankruptcy report that stunned the public was the fact that Lehman's audit firm had been aware of the billion-dollar transactions the company had used to window-dress its financial statements. According to the bankruptcy examiner, the Big Four audit firm had discussed those transactions on many occasions with company officials but had not insisted or, apparently, even suggested that the company disclose them in their financial statements or the accompanying notes.

The bankruptcy examiner also maintained that the audit firm had not properly informed Lehman's management and audit committee of an internal whistleblower's allegations that management was intentionally misrepresenting the company's financial statements. Because of alleged professional malpractice, Lehman's audit firm was among the parties the bankruptcy examiner suggested could be held civilly liable for the enormous losses suffered by the company's stockholders and creditors.

The Cotton Kings

Political unrest and poor economic conditions in their homeland prompted six million Germans to immigrate to the United States during the nineteenth century. Those immigrants included three brothers from Bavaria, the beautiful mountainous region of southeastern Germany. In 1844, 23-year-old Henry Lehman arrived in Montgomery, Alabama, a small city with fewer than 5,000 inhabitants in south central Alabama. Over the next few years, Henry's two brothers, Emanuel and Mayer, joined him in Montgomery.

The three brothers established a small retail store that stocked a wide range of merchandise including groceries, clothing, and hardware. Among the brothers' principal customers were cotton farmers from nearby rural areas who often paid for the merchandise they purchased with cotton bales. The brothers soon realized that there were more profits to be made in buying and selling cotton than operating a retail store, so they became cotton merchants.

By 1860, "King Cotton" ruled the South. The southern states accounted for three-fourths of the cotton produced worldwide. Cotton was also the nation's largest export, accounting for 60 percent of the U.S.'s total annual exports. In 1858, the huge demand for cotton in New England's booming textiles industry had convinced the Lehman brothers to establish an office in lower Manhattan, just a few blocks from the Wall Street financial district. But the outbreak of the Civil War in 1861 forced the Lehmans, who supported the Confederacy, to close that office.

The economic embargo imposed by President Lincoln on the South during the Civil War meant that cotton merchants such as the Lehman brothers lost their biggest market. Because the Lehmans realized that the demand for cotton would spike dramatically following the war, they bought large quantities of cotton produced during the war years and stored it in well-hidden warehouses scattered across the South. The post-war profits the brothers realized from selling that cotton helped them reestablish their firm as one of the South's largest cotton merchants following the war. By 1870, the Lehman brothers had reopened their New York City office; a short time later, they made that office the headquarters of their business.

In the latter decades of the nineteenth century, the Lehman brothers gradually expanded their business to include the trading of other commodities, such as coffee, sugar, wheat, and petroleum products. The three brothers also decided to purchase a seat on the New York Stock Exchange. They realized that there was a need for financial intermediaries to funnel private investment capital to the large companies that were fueling the nation's rapid economic growth. Because of the nature of their

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business, the three brothers were well acquainted with the banking and credit industries and believed they could use that experience to easily segue into the emerging and very lucrative investment banking industry.

By the early years of the twentieth century, the Lehman firm, which by then was being managed by the second generation of the Lehman family, had cut its ties to the cotton industry and focused its attention almost exclusively on investment banking. During that time frame, the firm served as the underwriter for several companies that would become stalwarts of the U.S. economy. These companies included B.F. Goodrich, Campbell Soup, F.W. Woolworth, R.H. Macy & Co., and Sears, Roebuck & Co.

Investment banks facilitate the flow of investment capital in a free market economy by effectively "pricing risk." That is, investment bankers help buyers and sellers determine the appropriate relationship between the risk posed by given securities and the price at which those securities should be initially sold. This pricing process helps ensure that scarce investment capital is allocated in an efficient manner to corporations, other business organizations, and governmental agencies that need external funds to finance their operations.

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Investment banking firms face a wide range of business risks. For example, investment banks sometimes absorb large losses on new client securities that they acquire during the underwriting process and are unable to sell to third parties. The most important factor contributing to the risk profile of investment banks is the degree of financial leverage they utilize. Similar to commercial banks, investment banks rely heavily on debt capital rather than invested capital. This high degree of financial leverage typically results in significant profits accruing to the firms' stockholders in a strong economic environment when the investment banking industry prospers. On the other hand, during economic downturns, investment banks often incur large losses that wipe out much of their stockholders' equity.

Throughout its history, Lehman Brothers experienced the highs and lows of the volatile business cycle common to the investment banking industry. The intensity of that cycle was magnified by a new line of investment products that Lehman and its competitors made popular on Wall Street during the 1990s.

Playing with Fire

Lehman Brothers and the other large investment banks became major players in the financial derivatives markets that emerged in the final decade of the twentieth century. Investopedia (www.investopedia.com) defines a financial "derivative" as follows:

> *A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage.*

Many types of financial derivatives have existed for decades, including the most generic, namely, put and call options on common stocks. In the mid-1990s, however, a new genre of exotic financial derivatives became increasingly prevalent. These new derivatives included collateralized debt obligations, credit default swaps, and interest rate swaps, among many others. Institutional investors accounted for the bulk of the trading volume in these new securities because they were poorly understood and thus shunned by most individual investors.

The new breed of derivatives produced large and profitable revenue streams for the investment banking industry. On the downside, the risks posed by these new securities were often difficult to assess, which, in turn, made those risks difficult, if

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not impossible, to manage. Some economists and Wall Street experts suggested that the risks posed by many of these derivatives were, in fact, disproportionately high compared to the rates of return they generated. Further enhancing the risk profile of these investments was the fact that they were subject to only minimal regulatory oversight.

In a 2009 retrospective overview of the securities markets, President Obama observed that over the prior two decades those markets had been characterized by "wild risk-taking."[2] The president added that many of the new securities that became popular during that time frame were so complex and multifaceted that the "old regulatory schemes" developed for the securities markets in the 1930s did not provide adequate oversight for them.

Lehman flourished financially as the derivatives markets mushroomed in size and prominence during the 1990s and beyond. The firm was particularly active in the market for residential mortgage-backed securities (RMBS). By the turn of the century, government agencies, brokerage firms, and investment banks were producing a huge volume of RMBS each year. This "securitization" process involved purchasing residential mortgages from the 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 purchasers of RMBS were actually purchasing a claim on the cash flows generated by the mortgages that "backed" those securities. By 2004, Lehman produced more RMBS annually than any other entity.[3]

The high yields on RMBS created a surging demand for these new hybrid securities. In turn, the increasing demand for RMBS caused mortgage originators to become increasingly aggressive in extending loans to individuals who in years past had not been able to qualify for a home mortgage because of an insufficient income, a poor credit history, or other issues. These mostly first-time home buyers were referred to as "subprime" borrowers. Mortgage originators were not concerned by the sizable default risk posed by subprime borrowers since they intended to sell their loans "downstream" and thereby transfer that risk to the purchasers of RMBS.

The critical factor that influenced the riskiness of RMBS was the underlying health of the housing market in the United States. Steadily rising housing prices during the decade from 1995 through 2005 made the default risk on residential mortgages minimal. Wall Street analysts warned, however, that a downturn in housing prices would trigger a rise in mortgage defaults that would be problematic for parties having significant investments in RMBS. On the other hand, a sudden and sharp downturn in housing prices could prove to be catastrophic for those investors. Sadly, the latter doomsday scenario took place.

Housing prices peaked in the United States in 2006. By late 2007, housing prices had begun to tumble, declining in many residential markets by 20 percent or more by mid-2008. In some of the residential markets that had seen the sharpest increases over the previous several years, such as Las Vegas and south Florida, housing prices plunged by 50 percent.

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2. S. Labaton, "Obama Sought a Range of Views on Finance Rules," *The New York Times* (online), 17 June 2009.

3. Lehman purchased a large portion of the residential mortgages that it securitized from New Century Financial Corporation, one of the nation's major subprime mortgage companies. Case 1.7 documents New Century's brief and turbulent history.

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Falling housing prices caused a growing number of U.S. homeowners to be "upside down," meaning that the market values of their homes were lower than the unpaid balances of their mortgages. By early 2008, an estimated 9 million Americans had a negative equity in their homes, which caused a rapid rise in mortgage defaults and foreclosures. It was only a matter of time before the sharp decline in housing prices undercut the market for RMBS.

Government agencies, large institutional investors, and investment banks having an ownership interest in RMBS suddenly found the value of those securities spiraling downward when it became obvious that housing prices would continue their freefall. In some cases, the markets for mortgage-backed securities simply "froze," meaning that the securities could not be sold at any price. Lehman was among those entities that held a large inventory of mortgage-backed securities when the housing market crumbled. At the end of 2007, the company owned nearly $90 billion of those "toxic" assets. By comparison, Lehman's total stockholders' equity at the time was only $22.5 billion.

Prior to the collapse of the housing market, Lehman's high-risk business model had produced a string of record-breaking years. Exhibit 1 presents a financial highlights table for Lehman for the five-year period 2003 through 2007, which is a condensed version of a similar table included in the company's 2007 annual report. Notice that during that time period the company reported record revenues and net income each successive year. Lehman's string of impressive reported operating results continued in early 2008. When the company posted stronger than expected results for the first quarter of 2008, the price of its common stock soared by nearly 50 percent in one day.

Lehman's top executives profited enormously from the consistently strong reported financial performance of their company. Richard Fuld served as Lehman's chief executive officer (CEO) from 1994 through 2008. Over that time, Fuld earned nearly $500 million in compensation. In addition to monetary rewards, Lehman's executives were lavished with praise and accolades. Just as Lehman's financial empire was beginning to buckle in 2008, *Barron's* included Fuld in its list of the top 30 CEOs nationwide and tagged him with the title of "Mr. Wall Street."

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.

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Despite the glowing operating results reported for fiscal 2007 and the first quarter of 2008, Lehman's management recognized that the company faced daunting challenges. "Lehman was publicly presenting a rosy outlook about its future while it was privately scrambling for a solution to its deepening problems."[4] Complicating matters for Lehman's management was the fact that financial analysts and other parties closely monitoring the investment banking industry had begun raising serious questions regarding the company's financial health. Those questions stemmed primarily from two issues facing Lehman, one of which was the mayhem taking place within the housing market. The second and more important issue facing the large investment banking firm was the fact that it was "wildly overleveraged."[5] This issue was critical because by this time there was a general consensus on Wall Street that an investment bank's degree of financial leverage was the most important metric to use in evaluating its financial health.

Lehman's financial highlights table in Exhibit 1 presents two measures of financial leverage. The company's conventional leverage ratio was computed by dividing total assets by total stockholders' equity. At fiscal year-end 2007, this ratio was 30.7 for Lehman, meaning that the company had only $1 of stockholders' equity for every $30.70 of assets that it held. In the company's 2007 annual report, Lehman's management suggested that the "net leverage ratio" was a much better measure of the company's financial leverage than the conventional leverage ratio. In computing the net leverage ratio, the company excluded from total assets a large volume of "low-risk" assets. Notice that Lehman's 2007 net leverage ratio was nearly fifty percent lower than its conventional leverage ratio.

The importance being ascribed to Lehman's leverage ratios, in particular, its net leverage ratio, by financial analysts in late 2007 prompted Dick Fuld to order a company-wide "deleveraging strategy." In an intercompany communication during this time frame, one of Fuld's subordinates noted that "reducing leverage is necessary to . . . win back the confidence of the market, lenders, and investors."[6] Another of Fuld's subordinates subsequently testified that beginning in late 2007 "Lehman set balance sheet targets with an eye to reaching [reducing] certain leverage ratios that rating agencies used to measure and gauge Lehman's performance."

Lehman's management chose an unconventional method to reduce the company's net leverage ratio. This improvised tactic involved engaging in a large volume of "accounting-motivated" transactions, known internally as Repo 105 transactions, near the end of each quarterly reporting period. Because the Repo 105 transactions were not disclosed in Lehman's SEC filings, third-party financial statement users were unaware that the company's net leverage ratio was being intentionally "sculpted" by management. "Lehman never disclosed that its net leverage ratio—which Lehman publicly touted as evidence of its discipline and financial health—depended upon the Repo 105 practice."

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4. L. Story and B. White, "The Road to Lehman's Failure Was Littered With Lost Chances," *The New York Times* (online), 6 October 2008.

5. D. Leonard, "How Lehman Brothers Got Its Real Estate Fix," *The New York Times* (online), 3 May 2009.

6. This and all subsequent quotes, unless indicated otherwise, were taken from the following source: *In re*: *Lehman Brothers Holdings Inc., et al., Debtors*, "Report of Anton R. Valukas, Examiner," U.S. Bankruptcy Court for the Southern District of New York, Chapter 11 Case No. 08-13555, 11 March 2010.

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Repo Central

In a repurchase or "repo" agreement, one party sells securities to another party while making a contractual commitment to repurchase those securities at a later date. The agreed-upon repurchase price for the given securities is nominally greater than the original selling price. In substance, the original "seller" of the securities is actually borrowing money from the original "purchaser" and using the securities transferred to the purchaser as collateral for the loan. The difference between the original selling price and the repurchase price is the interest earned on the loan by the original purchaser.

Another feature of repo transactions is what is known as the "haircut." The borrowing party (seller) transfers more than the face value of the securities involved in the transaction as collateral to the lender (purchaser). For example, if Lehman borrowed $100 million from another party under a conventional repo agreement, it would transfer more than $100 million of securities to the lender to serve as collateral for the loan. The haircut for Lehman's normal repos was typically two percent. So, in the example just provided, Lehman would have transferred $102 million of securities to the lender even though the actual amount of the loan was only $100 million.

Repos are a common financing tool used by large companies that need to raise a significant amount of funds for a short period of time. Repo lenders, on the other hand, view these transactions as a relatively safe way to invest excess cash at a modest rate of return without "tying up" those funds for an extended period of time. Similar to other investment banks, Lehman used repos as a major source of short-term financing.

For accounting purposes, repo agreements are nearly always treated as financing (borrowing) transactions by the borrower rather than as true sales of securities—Lehman recorded all of its normal repos as financing transactions. This accounting treatment is dictated by *Statement of Financial Accounting Standards (SFAS) No. 140*, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." When certain unusual conditions are met, however, *SFAS No. 140* provides for an exception to this general rule, meaning that repo borrowers can record the transactions as sales of securities.[7]

Lehman's executives realized that the *SFAS No. 140* exception could be used to their advantage, namely, to reduce their company's net leverage ratio. The lynchpin of this strategy was engaging in a large volume of "Repo 105s" that were repurchase agreements that the company recorded as sales rather than as financing transactions. The company's justification for treating a Repo 105 as a sale was the size of the "haircut" involved in the transaction. For Repo 105s, the amount of the haircut was 5 percent—which explained the label applied to them by the company. Lehman's accounting staff maintained that the larger haircut for the Repo 105s allowed them to be treated as sales under the exception included in *SFAS No. 140*.[8,9] Because this interpretation of *SFAS No. 140* was controversial, prior to engaging in any Repo 105s, company management decided to obtain a legal opinion confirming that the transactions could be considered "true sales" of securities.

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7. *SFAS No. 140* has been revised in recent years, principally by *SFAS No. 166*, "Accounting for Transfers of Financial Assets."

8. Lehman Brothers' detailed justification for this accounting treatment is documented in several sources, including a lengthy explanation in the bankruptcy examiner's report. For a more concise discussion of Lehman Brothers' defense of this accounting treatment, see the following source: S.K. Dutta, D. Caplan, and R. Lawson, "Poor Risk Management," *Strategic Finance*, August 2010, 23–29. Essentially, Lehman maintained that the larger haircut involved in a Repo 105 was evidence that it had surrendered control over the securities transferred to the other party, a condition required for a repo to be treated as a sale under *SFAS No. 140*.

9. Recognize that the "haircut" is not equal to the amount of interest paid by the borrower to the lender in a repo transaction. Since repos tend to be for a short period of time, the amount of interest paid by the borrower is typically a fraction of 1 percent, although the annualized interest rate might be, for example, 8 percent.

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Lehman's management could not find a law firm in the United States willing to issue a legal opinion that Repo 105s were true sales. Undeterred, the company's executives began searching for a foreign law firm that would issue such an opinion. The law firm that the company eventually retained for that purpose was Linklaters, a large British firm.

> *Unable to find a United States law firm that would provide it with an opinion letter permitting the true sale accounting treatment under United States law, Lehman conducted its Repo 105 program under the aegis of an opinion letter the Linklaters law firm in London wrote for LBIE, Lehman's European broker-dealer in London, under English law.*

Because the Repo 105s had to be consummated in Great Britain, Lehman transferred securities that would be involved in those transactions from a U.S. division of the firm to a British-based division, namely, Lehman Brothers International Europe (LBIE), its London-based brokerage. Although these transactions were consummated in Great Britain, they were ultimately included in Lehman's consolidated financial statements issued in the United States.

There were actually two "legs" to each Repo 105 transaction. The first leg involved the "sale" of the securities to a third party; in the second leg of these transactions, Lehman used the proceeds from the sale to pay off a portion of its outstanding liabilities. When taken together, the two legs of Repo 105 transactions allowed Lehman to reduce its net leverage ratio and thereby strengthen its apparent financial condition.

Recognize that the impact of the first leg of a Repo 105 on net assets was zero. When securities were sold in a Repo 105, the journal entry to record the transaction included a "debit" to a cash account that was offset by an equal "credit" to the appropriate investments account.[10] However, the second leg of the transaction, that is, the use of Repo 105 cash proceeds to pay down liabilities, resulted in Lehman's total assets being reduced, which, in turn, reduced Lehman's net leverage ratio. The accounting treatment applied to conventional repos, which were simply recorded as short-term loans, did not yield this "leverage-reduction" benefit.[11]

Lehman's bankruptcy examiner documented the fact that the volume of Lehman's Repo 105s spiked dramatically at the end of each quarterly reporting period. This opportunistic timing of the transactions allowed the company to significantly reduce its net leverage ratio just days or even hours before its accounting staff "closed" the accounting records to prepare the company's quarterly or annual financial statements. A few days later, Lehman would reverse or unwind the Repo 105s by re-acquiring the given securities with newly-borrowed funds. At the end of fiscal 2007, Lehman had $39 billion of "open" Repo 105 transactions; three months later, that figure had risen to $50 billion.

Lehman's use of Repo 105s to strengthen its reported financial condition in 2007 and 2008 was the major focus of the 2200-page report that was filed by the company's bankruptcy examiner with a federal court. Particularly appalling to the bankruptcy examiner was the efforts of Lehman's management to draw attention to the company's declining leverage while concealing the fact that Repo 105s were responsible for much of that improvement. In "earnings calls" with financial

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10. This is a brief and simplified summary of the accounting treatment applied to Repo 105s by Lehman. Examples of hypothetical accounting entries used by Lehman to record its Repo 105 transactions are presented in the following article: S.K. Dutta, D. Caplan, and R. Lawson, "Poor Risk Management," *Strategic Finance*, August 2010, 23–29.

11. The conventional strategy for reducing the net leverage ratio would have been to simply sell assets and then use the proceeds to pay down liabilities. Lehman could not avail itself of that strategy since the markets for the assets (investments) that it had available for sale were highly illiquid. To sell those assets, Lehman would have been forced to absorb large losses, losses that would have reduced its stockholders' equity and thus largely negated the intended reduction of its net leverage ratio.

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analysts tracking Lehman's stock, for example, the company's chief financial officer (CFO) stressed the fact that the company's financial leverage was being reduced; however, she "said nothing about the firm's use of Repo 105 transactions." At the same time, the CFO told those analysts that her company was committed to providing them "a great amount of transparency" regarding the company's balance sheet.

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The bankruptcy examiner maintained that even if the accounting treatment applied to the Repo 105s technically complied with *SFAS No. 140*, that accounting treatment violated Generally Accepted Accounting Principles (GAAP) by causing Lehman's financial statements to be misleading. To support his position, the bankruptcy examiner referred to a ruling handed down by a federal district court in a case involving an accounting matter. "GAAP itself recognizes that technical compliance with particular GAAP rules may lead to misleading financial statements, and imposes an overall requirement that the statements taken as a whole accurately reflect the financial status of the company."

According to the bankruptcy examiner, there had been no underlying business purpose for the Repo 105s. Instead, the sole purpose of the transactions had been to make Lehman's "balance sheet appear stronger than it actually was." In sum, the transactions had been "accounting-motivated." The bankruptcy examiner referred to a prior SEC release to define that term.

> *"Accounting-motivated structured transactions" are "transactions that are structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction, and thereby impair the transparency of financial reports." [Attempts] to portray the transactions differently from their substance do not operate in the interests of investors, and may be in violation of the securities laws.*

The bankruptcy examiner uncovered numerous instances of intercompany communications that suggested the Repo 105s had been accounting-driven. In responding to an inquiry regarding why Lehman was engaging in a large volume of Repo 105s at the end of each quarter, one company executive had told another, "It's basically window-dressing. We are calling repos true sales based on legal technicalities." Another company executive testified that "It was universally accepted throughout the entire institution [company] that Repo 105 was used for balance sheet relief at quarter end." A lower-level Lehman employee had referred to Repo 105s as an "accounting gimmick" and a "lazy way of managing the balance sheet." Finally, a high-ranking accounting officer admitted to the bankruptcy examiner that "there was no substance to these transactions" and that their only "purpose or motive was reduction [of assets] in the balance sheet."

Further validating the bankruptcy examiner's argument that the Repo 105s had been purely accounting-driven was the fact that they had been more expensive than Lehman's normal repo transactions. That is, the company could have secured the short-term financing provided by the several hundred billions of dollars of its Repo 105s at a lower cost by using conventional repo agreements. "Lehman could have obtained the same financing at a lower cost by engaging in ordinary repo transactions with substantially the same counterparties using the same assets involved in the Repo 105 transactions."

When considering the issue of whether the accounting treatment applied to the Repo 105s made Lehman's financial statements *materially* misleading, the bankruptcy examiner effectively invoked the definition of that construct found in *Statement of Financial Accounting Concepts No. 2*, "Qualitative Characteristics of Accounting Information."

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The magnitude of an omission or misstatement of accounting information that, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

The bankruptcy examiner surveyed a wide range of "reasonable" parties that had relied on Lehman's financial statements. Nearly all of these parties insisted that they would have wanted to know that the company was using the Repo 105 transactions to distort its balance sheet and key financial ratios. "Lehman's directors, the rating agencies, and government regulators—all of whom were unaware of Lehman's use of Repo 105 transactions—have advised the examiner that Lehman's Repo 105 usage was material or significant information that they would have wanted to know." In fact, in 2008, the controller of Lehman's European operations had e-mailed a Lehman colleague in the United States and warned him that the Repo 105s "are understating what we have at risk by a material amount especially around quarter ends." The bankruptcy examiner relied on such statements in arriving at his decision that a "trier of fact," that is, a court, would likely find that the Repo 105s had resulted in Lehman's financial statements being materially misleading.

To bolster this conclusion, the bankruptcy examiner referred to a discussion of materiality included in the 2007 workpapers of Lehman's independent audit firm, Ernst & Young. "Indeed, audit walk-through papers prepared by Lehman's outside auditor, Ernst & Young, regarding the process for reopening or adjusting a closed balance sheet stated: 'Materially is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion). Repo 105 moved net leverage not by tenths, but by whole points." As shown in Exhibit 1, Lehman's reported net leverage ratio as of the end of fiscal 2007 was 16.1. According to the bankruptcy examiner, the actual ratio would have been 17.8 if the company had accounted for the Repo 105s as financing transactions.

During his investigation, the bankruptcy examiner spent considerable time reviewing the Ernst & Young (E&Y) audit workpapers. The prominent accounting firm ultimately became a major focus of that investigation and the target of scathing criticism by the bankruptcy examiner.

Auditors on the Firing Line

E&Y served as Lehman's independent audit firm from 1994 through 2008. For the 2007 audit, the final audit of the company prior to its collapse, Lehman paid E&Y approximately $29.5 million. That figure included the fee for the 2007 audit, fees for tax services provided to the company, and miscellaneous fees. William Schlich served as the engagement audit partner for the 2007 audit of Lehman. In July 2008, Schlich, a longtime E&Y partner, was named the head of E&Y's "Global Banking & Capital Markets" practice, the firm's largest individual industry practice.

Lehman's bankruptcy examiner interviewed Schlich extensively during his investigation. Schlich told the bankruptcy examiner that E&Y had been aware of the Repo 105 transactions and was also aware that Lehman had not disclosed the transactions in financial statements filed with the SEC. Schlich also revealed that Lehman officials had consulted with E&Y while they were developing the company's Repo 105 accounting policy, although he reported that his firm had not been directly involved in that process and had not formally approved the accounting policy.

Martin Kelly, Lehman's former Financial Controller, testified that he discussed the Repo 105 transactions with Schlich in late 2007. Kelly told the bankruptcy examiner that he had a certain degree of "discomfort" with the Repo 105s, ostensibly because

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