Lehman had been unable to obtain a legal opinion from a U.S. law firm that supported the company's decision to record those transactions as sales of securities. Kelly recalled that he had discussed Lehman's inability to obtain such a legal opinion with the E&Y auditors.

Surprisingly, Schlich told the examiner that he did not know whether anyone on the E&Y engagement team had actually reviewed the legal opinion on the Repo 105 transactions issued by Linklaters, the British law firm. Schlich suggested that the responsibility for reviewing that letter would have rested with his firm's British affiliate, E&Y United Kingdom, which had audited the accounting records of LBIE, the British arm of Lehman Brothers that had executed the Repo 105 transactions.

Throughout his investigation and in his report, the bankruptcy examiner repeatedly characterized the Repo 105s as "accounting-motivated" transactions without an underlying business purpose that had been intended to embellish Lehman's financial statements and its net leverage ratio. While being interviewed by the examiner, however, Schlich staunchly defended the accounting treatment that had been applied to those transactions. The E&Y partner insisted that the "off-balance sheet treatment" of the Repo 105s was purely a "consequence of the accounting rules" rather than the underlying "motive for the transactions." When the examiner asked Schlich whether "technical adherence" to *SFAS No. 140* or any other specific accounting rule could have resulted in Lehman's financial statements being misstated, "Schlich refrained from comment." On two occasions, the examiner "offered Ernst & Young the opportunity" to explain or identify the "business purpose of Lehman's Repo 105 transactions." On each occasion, the E&Y representative (apparently Schlich) "declined that invitation."

The bankruptcy examiner subsequently criticized E&Y for not addressing the possibility that Lehman's "Repo 105 transactions were accounting-motivated transactions that lacked a business purpose." According to the examiner, E&Y should have recognized, or at least considered the possibility, that the Repo 105s were simply intended to improve Lehman's apparent financial condition, in particular, its net leverage ratio. The examiner stated that there was "no question that Ernst & Young had a full understanding of the net leverage ratio" and that the auditors understood the importance of that ratio to third-party financial statement users.

The bankruptcy examiner focused considerable attention on the materiality of the Repo 105 transactions while he was interviewing Schlich. At one point, the examiner asked Schlich what volume of Repo 105 transactions would have been considered "material" by E&Y. "Schlich replied that Ernst & Young did not have a hard and fast rule defining materiality in the balance sheet context, and that, with respect to balance sheet issues, 'materiality' depends upon the facts and circumstances." In his report, the bankruptcy examiner juxtaposed this statement of Schlich with the fact that E&Y's 2007 Lehman workpapers had identified the following precise materiality threshold for the company's net leverage ratio: "Materiality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion)."

When questioned further regarding the materiality of the Repo 105s, Schlich told the bankruptcy examiner that E&Y's audit plan had not required the Lehman engagement team to "review the volume or timing of Repo 105 transactions." Consequently, "as part of its year-end 2007 audit, E&Y did not ask Lehman about any directional trends, such as whether its Repo 105 activity was increasing during fiscal year 2007." The bankruptcy examiner reported that Schlich was unable to "confirm or deny that Lehman's use of Repo 105 transactions was increasing in late 2007 and into mid-2008."

A final major issue raised with William Schlich by the bankruptcy examiner was E&Y's response to the whistleblower letter sent to company management in May 2008 by a senior member of Lehman's accounting staff. Lehman's management had asked E&Y to be involved in investigating the allegations in that letter.[12] Among other allegations, the whistleblower suggested that Lehman's assets and liabilities were routinely misstated by "tens of billions of dollars" in the company's periodic balance sheets. To remind his superiors of their responsibilities related to financial reporting, the whistleblower had included in his letter the following excerpt from Lehman's Code of Ethics.[13]

> *All employees . . . must endeavor to ensure that information in documents that Lehman Brothers files with or submits to the SEC, or otherwise discloses to the public, is presented in a full, fair, accurate, timely and understandable manner. Additionally, each individual involved in the preparation of the Firm's financial statements must prepare those statements in accordance with Generally Accepted Accounting Principles, consistently applied, and any other applicable accounting standards and rules so that the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the Firm.*

Approximately four weeks passed before E&Y interviewed the author of the whistleblower letter. Schlich and Hillary Hansen, another E&Y partner, conducted that interview. Hansen's handwritten notes compiled during the interview indicated that the whistleblower alleged that Lehman had used tens of billions of dollars of Repo 105 transactions to strengthen its quarter-ending balance sheets. According to the examiner, E&Y never interviewed the whistleblower a second time and never "followed up" on his allegation regarding Lehman's improper use of Repo 105s.

The day after interviewing the whistleblower, E&Y auditors met with Lehman's audit committee but, according to the bankruptcy examiner, did not inform the committee members of the whistleblower's Repo 105 allegation. Three weeks later, E&Y auditors met once more with Lehman's audit committee and again reportedly failed to mention that allegation. The bankruptcy examiner subsequently reviewed E&Y's work papers for the 2007 audit and the 2008 quarterly reviews and "found no reference to any communication with the audit committee about Repo 105."

During his interview with the bankruptcy examiner, Schlich indicated that he did not recall the whistleblower mentioning the Repo 105 transactions when he and Hansen met with him. When informed that Hansen's handwritten notes of that meeting indicated that the whistleblower had referred to those transactions, Schlich "did not dispute the authenticity" of those notes.

In summarizing his investigation of E&Y's role as Lehman's auditor, the bankruptcy examiner reported that there was "sufficient evidence to support at least three colorable claims that could be asserted against Ernst & Young relating to Lehman's Repo 105 activities and reporting."[14] The first colorable claim involved E&Y's alleged failure to "conduct an adequate inquiry" into the whistleblower's allegations and failing "to properly inform management and the audit committee" of those allegations. Second, the bankruptcy examiner charged that E&Y had failed to "take proper action" to investigate whether Lehman's financial statements for the first two quarters of 2008 were materially misleading due to the company's failure to disclose its Repo 105 transactions. The final colorable claim involved

12. After reading the whistleblower letter, Schlich confided to two colleagues in an e-mail that the letter was "pretty ugly" and that it "will take us a significant amount of time to get through."

13. The whistleblower was dismissed approximately one month after sending his letter to Lehman's top management. He was reportedly dismissed as a result of a corporate-wide "downsizing" campaign.

14. "Colorable claim" is a legal term. A colorable claim is generally a "plausible legal claim," that is, a claim "strong enough to have a reasonable chance of being valid if the legal basis is generally correct and the facts can be proven in court" (http://topics.law.cornell.edu).

E&Y's alleged failure to "take proper action" to investigate whether Lehman's financial statements for fiscal 2007 were materially misleading due to the Repo 105s.[15]

The allegations that the bankruptcy examiner filed against E&Y spawned widespread discussion and debate within the accounting profession. One accounting professor defended the accounting treatment that Lehman applied to its Repo 105s and, by implication, E&Y's tacit approval of that treatment. In responding to the question of whether Lehman was entitled to account for those transactions as sales of securities, the professor responded, "Absolutely. Even if intended to influence (or deceitfully change) the numbers reported? Yes, intent doesn't matter. It [Lehman] found a rule it could utilize to its advantage and followed it."[16] The professor went on to explain that the given "rule" was a bad one that should be amended.

Three other accounting professors expressed a very different point of view. These professors noted that "a fundamental financial reporting objective that overrides the application of any specific rule is that the accounting of a transaction should not obfuscate its economic substance."[17] The professors then noted that "parties with meaningful roles in the financial reporting process" shouldn't be involved in applying "accounting rules with the intent to obfuscate the economic substance"[18] of given transactions. Finally, the professors made the following observation regarding the professional responsibilities of the accountants and auditors involved in the Lehman debacle.

> *External auditors, internal auditors, and management accountants all have professional standards that are aspirational in nature, and, regardless of whether Lehman's auditors and accountants met the minimum standards that might shield them from legal liability and formal professional sanction, it seems clear that they fell short of the higher standards to which all management accountants and auditors should aspire.*[19]

EPILOGUE

The revelations and allegations included in the report issued by Lehman's bankruptcy examiner evoked an immediate response from the SEC. In March 2010, an SEC spokesperson reported that the federal agency had been unaware that Wall Street firms were using Repo 105-type transactions to enhance their apparent financial condition. The SEC revealed that it was contacting twenty major financial institutions to determine if they had used similar tactics to "manage" their balance sheets. To date, the SEC has not commented on the results of that survey or identified the specific firms that were contacted.

Lehman's bankruptcy report served as an "open invitation"[20] to file civil lawsuits against E&Y. And that is exactly what happened. Throughout 2010, numerous lawsuits that named E&Y as a defendant or co-defendant were filed on behalf of parties that suffered losses due to Lehman's collapse. Among these lawsuits, the one with arguably the highest profile was a civil fraud lawsuit filed against E&Y in late December 2010 by Andrew Cuomo, New York's

15. The bankruptcy examiner noted that E&Y "may have valid defenses" to the colorable claims that he asserted against the firm. The examiner discussed some of these defenses including the fact that many auditing standards do not impose "bright line rules" but instead provide only "general guidance" to auditors.

16. D. Albrecht, "Repo 105 Explained with Numbers and Detail," 24 April 2010, http://profalbrecht.wordpress.com/2010/04/24.

17. S.K. Dutta, D. Caplan, and R. Lawson, "Poor Risk Management," *Strategic Finance*, August 2010, 29.

18. *Ibid.*

19. *Ibid.*

20. Texas Society of Certified Public Accountants, "Accounting Web—April 2, 2010," http://www.tscpa.org.

Attorney General and Governor-elect. In commenting on the lawsuit, Cuomo noted that Lehman had been a "house-of-cards" and that E&Y had "helped hide" this fact "from the investing public."[21]

Shortly after the release of the Lehman bankruptcy report, E&Y issued the following statement defending its unqualified opinion on Lehman's 2007 financial statements: "Our opinion stated that Lehman's financial statements for 2007 were fairly presented in accordance with U.S. GAAP, and we remain of that view."[22] E&Y's statement went on to observe that "Lehman's bankruptcy was the result of a series of unprecedented adverse events in the financial markets . . . It was not caused by accounting issues or disclosures issues."[23]

E&Y's responses to Lehman-related lawsuits have typically included rebuttals of allegations initially made by the company's bankruptcy examiner. For example, E&Y has repeatedly insisted that the accounting treatment applied by Lehman to its Repo 105 transactions was GAAP-compliant. In a legal document filed with a federal court, E&Y's defense counsel maintained that Lehman's Repo 105s were properly recorded as true sales of securities under *SFAS No. 140*. [24] Likewise, E&Y has maintained that at the time Lehman was not required to disclose the Repo 105 transactions in its financial statements. E&Y's attorneys have pointed out that *SFAS No. 166*, "Accounting for Transfers of Financial Assets," which was issued in June 2009, now mandates such disclosure, which, from the attorneys' perspective, reinforces their argument that such disclosure was *not* required in 2007.[25]

Considerable attention was focused by the bankruptcy examiner on the impact that Lehman's Repo 105 transactions had on the company's reported net leverage ratio. E&Y, however, has pointed out that the ratio was not included in the company's audited financial statements and thus was not a "GAAP financial measure" subject to being audited.[26] E&Y has also strongly contested the assertion that the Lehman auditors failed to properly inform the company's audit committee of the allegations included in the infamous whistleblower letter received by Lehman's management in May 2008.

> *The media has inaccurately reported that E&Y concealed a May 2008 whistleblower letter from Lehman's Audit Committee. The whistleblower letter, which raised significant potential concerns about Lehman's financial controls and reporting but did not mention Repo 105, was directed to Lehman's management. When we learned of the letter, our lead partner promptly called the Audit Committee Chair; we also insisted that Lehman's management inform the Securities & Exchange Commission and the Federal Reserve Bank of the letter. E&Y's lead partner discussed the whistleblower letter with the Lehman Audit Committee on at least three occasions during June and July 2008.*[27,28]

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21. P. Lattman, "Cuomo Sues Ernst & Young Over Lehman," *The New York Times* (online), 21 December 2010.

22. M. Cohn, "Ernst & Young Defends Lehman Audits," *WebCPA*, 25 March 2010. (http://www.accountingtoday.com)

23. *Ibid.*

24. *In Re Lehman Brothers Equity/Debt Securities Litigation*, No. 08 Civ. 5523 (LAK), "Civil Action No. 09 MD 2017 (LAK), U.S. District Court for the Southern District of New York. E&Y's legal counsel contended that Lehman had relinquished "effective control" of the securities involved in the Repo 105 transactions and, as a result, was permitted to record those transactions as sales of securities under *SFAS No. 140*. Not surprisingly, the plaintiff attorneys disagreed with that interpretation of *SFAS No. 140*.

25. *Ibid.*

26. Texas Society of Certified Public Accountants, "Accounting Web—April 2, 2010." Recall that Lehman's net leverage ratio was included in a financial highlights table in its 2007 annual report. That ratio was also referred to in the Management's Discussion & Analysis (MD&A) section of that report.

27. Texas Society of Certified Public Accountants, "Accounting Web—April 2, 2010."

28. Notice that E&Y asserts that it discussed the whistleblower letter with Lehman's audit committee. The bankruptcy examiner, however, alleges that E&Y did not bring the Repo 105s to the attention of the audit committee members. E&Y is correct that the Repo 105s were not specifically identified in the whistleblower letter, although they were apparently alluded to in the letter and were referred to by the whistleblower during his subsequent interview with Schlich and Hansen.

Over the years to come, the gaggle of Lehman-related lawsuits that have been filed will work their way through the courts. No doubt, over that time frame a clearer picture will emerge regarding the veracity of the claims and counterclaims in those lawsuits as well as the veracity of the allegations made by Lehman's bankruptcy examiner.

Similar to the Enron and WorldCom fiascoes in the past, the Lehman debacle has prompted widespread calls for accounting, auditing, and financial reporting reforms. In particular, many parties critical of Lehman's accountants and auditors have urged rule-making bodies to clarify the accounting and financial reporting rules for complex transactions, such as Repo 105-type transactions. In fact, the Financial Accounting Standards Board attempted to do just that by issuing multiple amendments to *SFAS No. 140* in the aftermath of Lehman's collapse.

The authors of an article in a practice-oriented accounting periodical, however, suggest that promulgating new, more precise accounting rules is unlikely to prevent Lehman-type accounting scandals in the future. In their view, the most effective way to prevent the recurrence of such scandals is to develop a more robust "ethical culture" within the accounting profession, a culture that encourages accountants and auditors to embrace the profession's core values such as integrity, objectivity, and commitment to public service.

> *Ethical behavior is not about abiding by the law. Individuals and organizations can act legally and still be acting unethically. Ethical behavior is driven by compliance with a set of values that act as the touchstone for situational decisions where rules may not exist to cover every alternative.*[29]

Questions

1. When Lehman was developing its Repo 105 accounting policy, did E&Y have a responsibility to be involved in that process? In general, what role should an audit firm have when a client develops an important new accounting policy? Comment on an audit firm's responsibilities during and following that process.
2. 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? Defend your answer.
3. Do auditors have a responsibility to determine whether important transactions of a client are "accounting-motivated"? Defend your answer.
4. William Schlich implied that E&Y's British affiliate had the responsibility for reviewing the legal opinion issued by a British law firm regarding the treatment of Repo 105s as sales of securities. Do you believe that Schlich or one of his subordinates should have reviewed that letter? Why or why not? In general, how should the responsibility for different facets of a multinational audit be allocated between or among the individual practice offices involved in the engagement?
5. Lehman's net leverage ratio was not reported within the company's audited financial statements but rather in the company's financial highlights table and MD&A section of its annual report. 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?

29. Dutta *et al.*, "Poor Risk Management."