

# Lehman Brothers Holdings, Inc

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The largest corporate bankruptcy in US history

by David Jízdny

# Overview of LB Bankruptcy

15.09.2008 – LB files for bankruptcy

\$700 billion in assets when filed for bankruptcy

DJIA down 500 points (about 5%) within hours and more than 50% in 6 months

- Nearly \$3 trillion wiped out

Examiners 2200 page report released in 2010

- 20 million documents and 10 million emails reviewed, cost \$38 million
- Report showed that LB used accounting motivated transactions to misstate balance sheet
- Liabilities understated by as much as \$50 billion
- Questionable transactions never disclosed to SEC & audit firm was aware

# Used terms



Leverage ratio

Financial measurements that assesses the ability of a company to meet its financial obligations



RMBS

Residential mortgage backed securities

Bank sells mortgage and bundles mortgages in a pool, large bank buys this pool and sells MBS



REPO agreement

A short-term agreement to sell securities in order to buy them back at a slightly higher price



SFAS No 140

Statement of financial accounting standards

Accounting for transfers and servicing of financial assets and extinguishment of liabilities

# Background of LB

Started as a retail store in AL and transferred into cotton merchant

LB was largest cotton merchant in the South USA by 1860

Established office in NY in 1856, but later closed due to Civil War

Moved back to NY after Civil War and expended business to other commodities

Next generation focused on investment banking

LB served as underwriter for several large companies (Campbell, Sears)

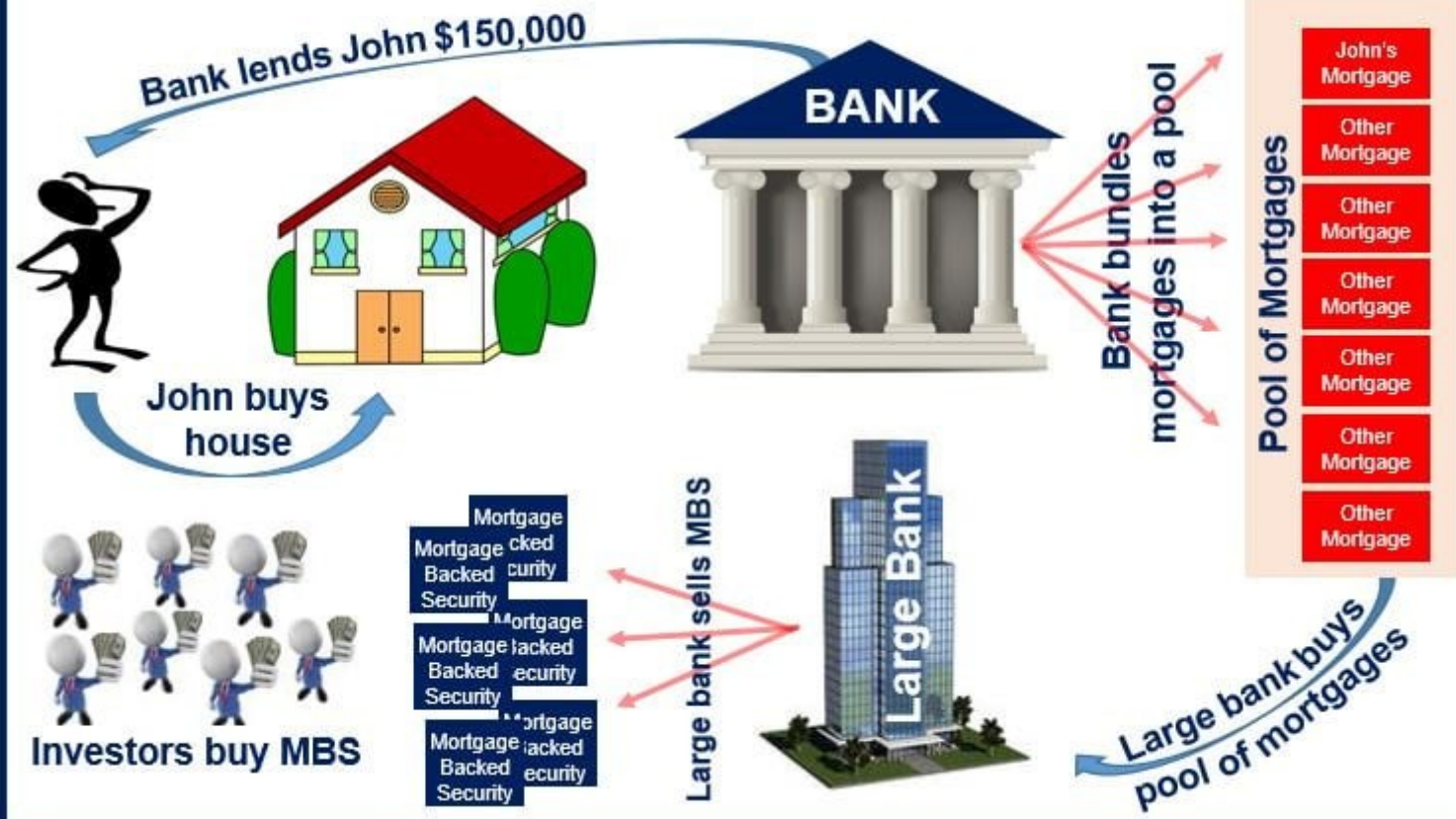
## Exploring Derivatives

- Very active in residential mortgage-backed securities (RMBS)
- By 2007 LB owned nearly \$90 billion of “toxic” derivatives
  - Shareholder equity only \$22,5 billion
- RMBS generated high profits before housing market crash
- Record revenues and income produced year after year

|                            | <u>2007</u> | <u>2006</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|----------------------------|-------------|-------------|-------------|-------------|-------------|
| 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.

# Mortgage-Backed Securities



# Low Leverage Ratio

Financial measurements that assesses the ability of a company to meet its financial obligations

Conventional leverage ration

Total assets / total stakeholder equity  
(30,7 in 2007)

Net leverage ration was much better measure for LB

Large volume of low risk assets excluded form total assets

Origination of REPO  
105 transactions

# REPO 105

- Known as a loophole for companies to hide true amounts of leverage
- A repurchase agreement that a company used to raise significant short term funds
  - If a company was able to repurchase back assets – considered financing transaction
  - If a company was NOT able to repurchase back assets - sale
- REPO 105 not disclosed in LB filing to SEC
- SFAS No. 140 provides for an exception in which repo borrowers can record the transaction as "sale of securities"



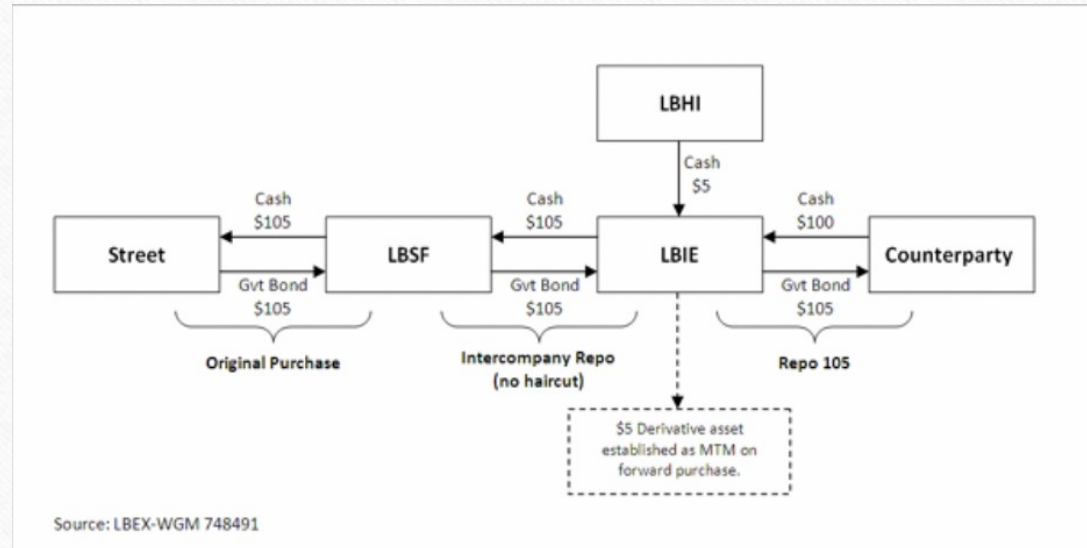
# REPO vs LB REPO 105

## Ordinary Repo Flow Diagram

**Transaction Start:** Lehman transfers securities to counterparty as collateral for a borrowing. Counterparty transfers cash to Lehman.



**Transaction End:** Lehman returns borrowed cash plus an interest payment. Counterparty returns collateral securities to Lehman.



Source: LBEX-WGM 748491

# SFAS No 140

- "Statement of Financial Accounting Standards"
- LB executives realized they can use it to their advantage
  - Didn't treat REPO 105 as financing transactions, but rather as sales of securities
- Intention is to reduce company's net leverage ratio
- Due to controversiality of this agreement, LB decided to get legal opinion
  - US law firms would not issue a statement on this; UK law firm say it is legal

# Transfers of REPO 105

- Since UK allowed these transactions
- Given securities had to be transferred from US division to UK division
- Transactions consumed in UK, but included on financial statements in US
- Volume of LB REPO 105 spiked dramatically at the end of each quarter period
  - Allowed the company to significantly reduce its net leverage ratio hours before staff closed the accounting record used for preparing financial statements

# Questionable behavior



CFO WAS PROUD ABOUT DECREASING LEVERAGE RATIO, BUT IN A CALL WITH FINANCIAL ANALYSTS MENTIONED NOTHING ABOUT USING REPO



CFO SAID IT WAS READY TO PROVIDE A GREAT AMOUNT OF TRANSPARENCY TO ANALYSTS



BANKRUPTCY EXAMINER SAW NO REASON FOR USING REPO 105 AND FOUND FINANCIAL STATEMENT MISLEADING



PUBLIC HAD NO IDEA ABOUT REPO 105 TRANSACTIONS

# Ernst & Young

- LB auditors 1994 – 2008
- Final audit cost approximately \$30 million
- William Schlich – engagement audit partner for 2007 audit
- E&Y was aware of REPO 105 and of the fact that LB didn't disclose transactions in financial statements filed with SEC
- LB officials were consulting E&Y when developing REPO 105
  - But E&Y was not directly involved and never formally approved it
- E&Y ignored the possibility of using REPO 105 for accounting motivated transactions

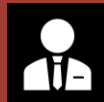
# E&Y Response to Whistleblower



Letter received by E&Y from senior member of LB



Whistleblower suggested that LB assets and liabilities were routinely misstated by tens of billions of dollars



E&Y interviews the whistleblower who tells them about using REPO 105s to strengthen their balance sheet



Few days later E&Y auditors met LB audit team, but no discussion about REPO 105 allegations



E&Y meets LB audit team 3 weeks later, but again REPO 105 not mentioned

# Bankruptcy Examiner Summary

- Examiner found sufficient evidence to support at least 3 claims against E&Y relating to LB REPO 105 activities
  - No proper inquiry and action about whistleblower's allegations
  - E&Y had failed failed to take proper action to investigate whether LB financial statements for the first 2 quarters of 2008 were materially misleading due to the company to disclose its REPO 105 transactions
  - E&Y failed to take proper action to investigate whether LB financial statements for fiscal 2007 were materially misleading due to REPO 105

|         |         |         |         |
|---------|---------|---------|---------|
| 125,058 | 154,568 | 95,054  | 124,500 |
| 125,487 | 56,845  | 97,511  | 125,000 |
| 124,000 | 110,000 | 99,011  | 154,000 |
| 1450    | 150,000 | 99,216  | 95,000  |
|         | 35,000  | 101,090 | 154,200 |
|         |         | 101,684 | 110,000 |
|         |         | 101,962 | 89,000  |
|         |         |         | 50,000  |
|         |         |         | 10,700  |

# Question 1

When Leman 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.

I think that they should not have been involved, but they should have warned LB that it might be doing something misleading. It should not just look how a company makes its balance sheet stronger just to boost their numbers and mislead the public. When a client develops a new accounting policy the audit firm should say whether the policy is ethically and morally correct or not. It should warn the company if it starts doing something that might be close to breaking the law.



## Question 2

Do you agree with the assertion that “intent does not 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.

I think that especially a publicly traded company should realize that it is the stockholders who provide them funds. To me, under no circumstances, a company should “cook their books” just to be more attractive for investment. It then only become a matter of time before the company collapses and files for bankruptcy.

# Question 3

Do auditors have a responsibility to determine whether important transactions of a client are “accounting motivated”? Defend your answer.

I don't thin that auditors should be determining anything. I think that they should monitor and notify the client if a problem arises. Like in many other cases, a part of LB's bankruptcy may be because the audit firm simply avoided the fact of LB making their balance sheet look stronger. Perhaps if the audit firm talked to the client and discussed it concerns over LB's transactions the disaster didn't have to be as big as it was.

# Question 4

William Schlich implied that E&Y's British affiliate had 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 responsibility for different facets of a multinational audit be collected between or among the individual practice offices involved in the engagement?

I think that the audit firm should have reviewed the letter. Simply because LB was using the REPO 105 to make its balance sheet look stronger. If the REPO 105 had nothing to do with the US branch of LB, with which E&Y had a contract, then it was not necessary in my opinion; but since the REPO 105 was connected to the US branch, then E&Y auditors should have reviewed the legal opinion issued by UK law firm.

# Question 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?

I think the major reason for an audit firm is to ensure the accuracy of given company's accounting and financial statements. If auditors notice some irregularity or questionable behavior then it should give them a notice that something might not be correct.

Thank you for your  
attention

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Questions?