CASE 1.2

LEHMAN BROTHERS HOLDINGS INC.

Synopsis

Wall Street was stunned in September 2008 when this iconic investment banking firm filed for bankruptcy. Two years later, there was a similar reaction within the investment community when Lehman's court-appointed bankruptcy examiner released his 2200-page report, the purpose of which was to identify the parties that could possibly be held civilly liable for the enormous losses suffered by Lehman's investors and creditors.

The focus of the bankruptcy examiner's report was hundreds of billions of dollars of allegedly "accounting-motivated" transactions that Lehman had used to enhance its apparent financial condition. Lehman's Repo 105s were short-term repurchase agreements that the company had chosen to record as "true sales" of securities under the auspices of the relevant accounting standard, namely, *SFAS No. 140*. The normal accounting treatment for repos is for the "seller" to record them as short-term loans. Why? Because most repos are, in substance, short-term loans in which the securities being "sold" are, in reality, simply the collateral for the given loan.

An exception to *SFAS No. 140* permits repo borrowers (sellers) to record these transactions as true sales of securities if they can demonstrate that they have "surrendered" control of the securities involved in the transactions. Lehman's management used this "loophole" in *SFAS No. 140* to significantly reduce its "net leverage ratio" and its reported liabilities by engaging in a huge volume of Repo 105 transactions. At the time, the most important metric that analysts used in monitoring the financial health of large investment banks was their degree of financial leverage—Lehman touted its net leverage ratio as the best measure of its financial leverage.

This case provides a brief historical overview of Lehman Brothers and then dissects the accounting and financial reporting issues related to the company's controversial use of Repo 105s. Of course, the principal purpose of this case is to examine the auditing issues raised by the Lehman debacle. The company's audit firm, Ernst & Young, was among the parties most criticized by Lehman's bankruptcy examiner. The bankruptcy examiner identified three "colorable claims" involving professional malpractice or negligence that could potentially be pursued in lawsuits filed against Ernst & Young. This case examines the auditing issues embedded in each of those claims.

Lehman Brothers Holdings, Inc.--Key Facts

1. Lehman Brothers, one of Wall Street's most prominent investment banking firms, became the largest corporate failure in U.S. history when it filed for bankruptcy in September 2008.

2. The release in March 2010 of a report by Lehman's court-appointed bankruptcy examiner prompted a public outcry when it revealed that Lehman had used multi-billion dollar "accounting-motivated" transactions to embellish its apparent financial condition during 2007 and 2008.

3. Similar to other investment banks, a key business risk factor for Lehman was the high degree of financial leverage that it employed; Lehman management persuaded financial analysts and other third parties that its "net leverage ratio" was the best measure of its degree of financial leverage.

4. The business risk faced by Lehman and the other major investment banks was amplified duringt the 1990s and beyond when they became heavily involved in the rapidly evolving and high-risk financial derivatives markets.

5. When housing prices began plummeting in the U.S. in 2007, Lehman's financial condition worsened dramatically since it had large investments in RMBS (residential mortgage-backed securities).

6. To enhance its reported financial condition and its net leverage ratio, Lehman developed a plan to engage in a large volume of Repo 105s, which were repurchase agreements accounted for as sales of securities (the customary accounting treatment for repos was to record them as short-term loans).

7. Accounting for repos as sales of securities was permitted under certain restrictive conditions identified by the relevant accounting standard, *SFAS No. 140*; however, Lehman could not find a U.S. law firm that would issue an opinion confirming that Repo 105s could be treated as sales.

8. Lehman executed the Repo 105s in Great Britain after finding a British law firm that would issue an opinion that they qualified as sales of securities; the Repo 105s allowed Lehman to reduce its net leverage ratio by as much as 10 percent and its reported liabilities by as much as $50 billion.

9. Among the parties that were most heavily criticized by Lehman's bankruptcy examiner in his report was the company's audit firm, Ernst & Young.

10. The bankruptcy examiner concluded that E&Y could potentially be held liable for failing to properly investigate a whisteblower's allegations that Lehman's financial statements were materially misstated and for allegedly failing to properly investigate the impact of Repo 105s on Lehman's quarterly and annual financial statements.

11. Numerous lawsuits stemming from Lehman's collapse named E&Y as a defendant or co-defendant; to date, E&Y has made more than $100 million in payments to settle such lawsuits.

Instructional Objectives

1. To examine the responsibility of auditors when a client implements a new and controversial accounting policy that has significant financial statement implications.

2. To examine the responsibility of auditors when clients have engaged in significant "accounting-motivated" transactions.

3. To identify auditors' responsibility to review or otherwise evaluate important "other information" that accompanies a client's audited financial statements.

4. To identify factors that should influence key materiality decisions made by auditors.

5. To identify the responsibilities of auditors when the integrity of a client's financial statements is challenged by a whistleblower.

6. To examine auditors' differing legal exposure in lawsuits filed in state courts versus federal courts.

Suggestions for Use

Here's another case that you could use as a launching pad for an undergraduate or graduate auditing course. This case will readily demonstrate to your students the huge challenges that auditors can face in carrying out their responsibilities and the critical importance of independent audits for not only individual companies but the national economy as well. Ernst & Young's audits of Lehman Brothers literally had economic implications for practically every U.S. citizen. In sum, I believe a case such as this can be used as an "attention grabber" for auditing students by conveying to them the importance of the professional responsibilities that they will soon be assuming.

The focal point of this case involves a critically important issue for accountants and auditors alike, namely, the bottom line objective of accounting and financial reporting standards. Lehman Brothers engaged in hundreds of billions of dollars of complex transactions that apparently had no express business purpose. Instead, the transactions were used ostensibly to window dress the company's financial statements, that is, to improve Lehman's critical net leverage ratio at a point in time when the company was literally coming apart at the seams. Although there is still some disagreement on this matter, there seems to be a general consensus that the "accounting loophole" that Lehman used to "pull off" this accounting charade was "legal" or permissible under *SFAS No. 140*, which was the relevant accounting standard. In fact, I tell my students to make that assumption prior to addressing the following question, which I use to kickoff the discussion of this case: *Is it permissible for reporting entities to use accounting standards to intentionally misrepresent their financial statements?* It is surprising to me that there is not complete consensus within the profession or even among academics within our profession on this issue—as pointed out in the case. As a point of information, I have found that the majority of my students typically express the view that entities should be allowed to apply a given accounting or financial reporting rule even if their express intent is to use that rule to embellish their apparent financial condition and/or operating results.

You may want to point out to your students that U.S. accounting standards do not currently include a rule equivalent to the "true and fair override" rule embedded in IFRS—that rule requires reporting entities to *not* apply an accounting standard if it would result in the given financial statements being misleading. However, the AICPA *Code of Professional Conduct*, "Accounting Principles," effectively includes such an "override" rule—see "Accounting Principles Rule," ET 1.320.001.

Suggested Solutions to Case Questions

1. No, auditors do not have an explicit responsibility to be involved in an audit client's process of developing new accounting policies. In the PCAOB's auditing standards, AS 1001.03 notes that "The financial statements are management's responsibility . . . [and] that management is responsible for adopting sound accounting policies. . ." AS 2110.07 requires auditors to obtain an understanding of "the company's selection and application of accounting principles." AU-C 315.12 of the AICPA Professional Standards observes that "The auditor should obtain an understanding of the . . . entity's selection and application of accounting policies, including the reasons for changes thereto." In addition to obtaining an understanding of a client's accounting policies, auditors should consider whether each accounting policy is "appropriate" as noted by AS 2110.12 and AU-C 315.12.

Recognize that auditors' need to obtain an understanding of a given accounting policy is enhanced when the policy involves "unusual" transactions or when a "significant" accounting policy involves "controversial" or "emerging" areas for which there is a lack of authoritative guidance or consensus [see AS 2110.13]. These circumstances certainly seem to apply to the situation that existed when Lehman was developing its Repo 105 accounting policy.

2. Again, for me, this question or issue is the focal point of the case—from both an accounting/financial reporting point of view and from an auditing perspective. In my view, the economic reality of a given transaction should be reflected in the accounting treatment applied to it. That is, I believe that "intent does matter" and that the underlying intent of the accounting treatment applied to a given transaction should be to ensure that the economic substance of the transaction is properly reflected in the given entity's financial statements and accompanying notes.

The principal conceptual basis for the argument outlined in the previous paragraph is the FASB's conceptual framework, that is, the Statement of Financial Accounting Concepts, in particular, *SFAC No. 8, "Conceptual Framework for Financial Reporting."* For example, *SFAC No. 8* notes that "To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from bias." [QC12] Of course, as pointed out by E&Y's legal counsel in lawsuits filed against the firm, the conceptual framework is not considered a component of GAAP. So, a violation of the "faithful representation" requirement is technically not considered a GAAP violation. [Note: *SFAC No. 8* was issued in September 2010. *SFAC No. 8* replaced *SFAC No. 2* which included a discussion of "representational faithfulness" that paralleled the "faithful representation" concept presented in *SFAC No. 8*.]

3. Recall that the SEC has specifically defined "accounting-motivated structured transactions" as follows:

> '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.

Auditors have an explicit responsibility to investigate whether the key management assertions underlying a given account balance, transaction, or financial disclosure is consistent with the presentation of that item in the relevant financial statements. By definition, accounting-motivated transactions would almost definitely violate one or more of those management assertions. For example, the classification assertion mandates that transactions and events be recorded in the proper accounts. You can imagine that a large proportion of accounting-motivated transactions would result in violations of the classification assertion.

So, my answer to this case question would be that auditors do have a responsibility to investigate whether client transactions are accounting-motivated. However, that responsibility is simply a by-product of applying an assertion-based audit strategy.

4. There was not a specific auditing standard that mandated that Schlich or one of his subordinates review the legal opinion issued by the British law firm. Having said that, given the critical importance of the Repo 105 transactions to Lehman's financial statements, it certainly seems that doing so would have been a "good idea." Reviewing that legal opinion would certainly have provided Ernst & Young with an enhanced "understanding" of the Repo 105 transactions [see answer to Question No. 1]. Granted, this observation is being made ex post. Recognize that Lehman developed the Repo 105 accounting policy shortly after *SFAS No. 140* was adopted in 2000. The company didn't begin engaging in a large volume of the Repo 105 transactions until several years later. So, even though it may not have seemed imperative for Ernst & Young to have reviewed the Linklaters' legal opinion when it was originally issued, years later when the volume of the Repo 105s increased dramatically, it seems reasonable to suggest that Ernst & Young should have at least considered reviewing that document.

On a large engagement involving multiple practice offices of an accounting firm, the engagement audit partner has the responsibility for overseeing the division of responsibilities on that engagement. In this case, that individual would have been William Schlich. Of course, on a large audit the engagement partner may delegate that administrative task to a subordinate. Nevertheless, the key point here is that the ultimate responsibility for administering the 2007 Lehman audit, including the allocation of the specific audit procedures to the practice offices involved in that audit, apparently rested with Schlich.

Notes: AU-C 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)" is relevant for audits of non-public companies. That relatively new auditing standard discusses the division of responsibilities on audits of "group financial statements," including the overarching responsibilities of the "group engagement partner." In the PCAOB's auditing standards, AS 1205, "Part of the Audit Performed by Other Independent Auditors," addresses circumstances in which multiple accounting firms are involved in an audit of an SEC registrant. AI 10 of the PCAOB's auditing standards includes "Interpretations" of AS 1205.

5. The relevant section of the PCAOB's auditing standards in this context is AS 2710, "Other Information in Documents Containing Audited Financial Statements."

AS 2710.04: "Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision."

AS 2710 goes on to discuss additional responsibilities that auditors have for "other information." For example, paragraph .05 discusses an auditor's responsibility when he or she discovers a "material misstatement" in "other information."

In the AICPA Professional Standards, AU-C Section 720, "Other Information in Documents Containing Audited Financial Statements," would be relevant to this question in the context of audits of entities other than public companies. AU-C Section 720 imposes responsibilities on auditors that are very similar to those included in AS 2710.

6. Since there isn't a "definitive" answer to this question, one objective you may want to accomplish in addressing it is to acquaint your students with the principal materiality "rules" or guidelines in the technical literature. Following are multiple viewpoints on materiality.

NOTE: *SFAC No. 2* was in effect when the key events in the Lehman case transpired. Included below is the FASB's reference to materiality in *SFAC No. 2* and in *SFAC No. 8*, which superseded *SFAC No. 2*. Finally, recognize that in early 2016, the FASB indicated that it might shift to a more legalistic definition of materiality, that is, one more consistent with U.S. Supreme Court rulings. Of course, the SEC's views on materiality parallel those of the Supreme Court.

FASB, SFAC No. 2: *Statement of Financial Accounting Concepts No. 2* defines materiality as follows: "the magnitude of an omission or misstatement of accounting information that, in the light of 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."

FASB, SFAC No. 8: "Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."

SEC: The SEC's principal statement regarding materiality can be found in *Staff Accounting Bulletin No. 99* issued in 1999. From the SEC's standpoint, an item is generally material if there is a "substantial likelihood" that a "reasonable investor" would "attach importance" to it in deciding whether or not to purchase a given security. Here's a key excerpt from *SAB No. 99*.

> An assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical percentage terms of the misstatement, it also includes the factual context in which the user of the financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

AICPA Professional Standards: AU-C Section 320, "Materiality in Planning and Performing an Audit," notes that "misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements" (paragraph .02).

PCAOB auditing standards: In AS 2105.02, the PCAOB embraces the Supreme Court and the SEC's definition of materiality.

For Lehman Brothers, there was no doubt that the company's apparent degree of leverage was a key issue being monitored closely by the parties tracking that company's financial data. So, it certainly seems reasonable for E&Y to have placed a disproportionate focus on that facet of Lehman's financial condition in arriving at key materiality benchmarks—apparently, the E&Y auditors did just that since they had an explicit materiality threshold related to Lehman's net leverage ratio.

7. Allegations of financial statement misrepresentations by a whistleblower are not one of the "standard" types of audit evidence identified professional auditing standards. Nevertheless, such allegations will nearly always relate to one or more of the management assertions around which auditors design their audit program or audit plan. For example, in this case, the whistleblower's allegations challenged the reliability of the "accuracy" assertion for total assets and liabilities as well as several other management assertions identified in the PCAOB's auditing standards and the AICPA Professional Standards. When whistleblower allegations challenge the reliability of management assertions for a given audit client, then certainly auditors have a responsibility to investigate those allegations.

No doubt, the first task of the auditor in this type of scenario will be to "consider the source." It may well be that the individual making the allegation is not credible and/or does not have access to information on which to base such an allegation. In such cases, the auditor will likely expend little time and effort investigating the given allegation. (By the way, the whistleblower in the Lehman case was very credible and had access to the company's accounting records since he was a member of the company's accounting staff.)

8. Most elements of proof do not vary between civil lawsuits filed against audit firms in the state and federal courts. For example, in either level of the court system, the plaintiff has to prove "damages," otherwise there is no basis for a lawsuit. The key factor that influences the legal exposure that audit firms face in state versus federal courts is the level of misconduct or malfeasance that the plaintiff must prove in order to prevail in a civil lawsuit filed against such a firm. When

suing an audit firm under the Securities Exchange Act of 1934, the plaintiff has to prove that the audit firm was more than negligent in performing the given audit. Federal courts require a plaintiff to establish that the defendant audit firm was either reckless or that scienter (intent to deceive) was present (this element of proof varies across individual federal courts—approximately one-half of the federal district courts require plaintiffs to establish at least recklessness, while the other one-half invoke the higher "scienter" standard).

The level of misconduct that plaintiffs must establish in the state courts to prevail in a civil lawsuit against an audit firm varies. For example, in some state courts, only primary beneficiaries (of a given audit) can sue an audit firm for negligence, while in other state court systems primary, foreseen, and reasonably foreseeable beneficiaries can sue auditors for negligence. If a state court system does not allow a plaintiff to sue an audit firm for negligence, then the plaintiff must file such a lawsuit predicated on gross negligence, recklessness, or fraud. As you can imagine, plaintiff legal counsel often engage in so-called "venue shopping" to find a court where their client is most likely to prevail.

Notes: recognize that very few civil lawsuits against audit firms are tried in the federal courts under the Securities Act of 1933. Why? Because that statute imposes a severe level of legal liability on third parties, such as auditors, associated with S-1 registration statements that contain material misrepresentations. So, audit firms nearly always settle such lawsuits out of court. (Of course, the 1933 Act doesn't apply in this case since that statute deals with initial SEC registration statements for companies going public.)