LAW AND ACCOUNTING: DID LEHMAN BROTHERS USE OF REPO 105 TRANSACTIONS VIOLATE ACCOUNTING AND LEGAL RULES?

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ABSTRACT

In September 2008, Lehman Brothers filed for bankruptcy. Lehman Brothers' bankruptcy was a critical event in the financial crisis. Prior to the bankruptcy filing, Lehman Brothers was able to use repurchase (Repo 105) transactions to disguise the true condition of the company. This paper addresses the use of Repo 105 at Lehman Brothers. At that time, the repurchase agreements were allowed to count as a sale rather than debt under Generally Accepted Accounting Principles; thus, Lehman understated their financial difficulties. Both the accounting principles, possible violations of U.S. securities law, and the conflict that results are examined. The authors conclude that as long as the conflict exists between what is expected of auditors (under accounting standards and GAAP) and the regulators and the law, Lehman-type events will continue to be likely.

INTRODUCTION

This article addresses both U.S. accounting standards and U.S. law by providing an analysis of repurchase agreements as used by the investment firm Lehman Brothers. The specific questions addressed are whether Lehman Brothers violated accounting and auditing standards and federal securities and financial regulation laws. This paper examines both the accounting practices and securities law and the conflict between them. At the time the repurchase agreements were used, the accounting treatment was considered acceptable under U.S. generally accepted accounting standards ("GAAP"). However, the authors conclude that the accounting treatment of the repurchase agreements, henceforth referred to as Repo 105 transactions, and the subsequent financial statement disclosures were done in violation of numerous U.S. laws. The contradiction between law and accounting/auditing standards is the focus of the article.

Prior to the collapse, Lehman Brothers was the 4th largest global financial services firm and the oldest of the five major global financial services firms ("Lehman Brothers"). In addition to Bear Stearns and AIG, Lehman Brothers was a major institution that failed during the financial crisis (McAfee & Johnson, 2010). The failure of Lehman Brothers is believed to have impacted financial markets for weeks ("Case Study: The Collapse of Lehman Brothers," 2009).

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While it was hardly the sole cause of the financial crisis, the failure of Lehman Brothers was a substantial event causing loss of confidence in the financial and banking systems. The Lehman Brothers event is considered so important in the minds of business and economic analysts that the terms "Lehman-type event" or "Lehman-type moment" is often used in the business press and business cable TV (such as CNBC). For example, analysts ask whether the possible fall of the Greek or Spanish economy would cause a worldwide catastrophe that would qualify as a "Lehman type event" (Kroft, 2012; CNBC, 2011; Pinetree Capital Ltd., 2012, Sandholm, 2011; Martinez, 2011). Lehman Brothers continues to make news with new lawsuits and news reports.

On September 15, 2008, Lehman Brothers filed for bankruptcy. The Lehman Brothers bankruptcy is the largest reported U.S. bankruptcy –twice as large as the second, Washington Mutual ("The Ten Largest Bankruptcies", 2009). Bank debt at Lehman Brothers was $613 billion. The bankruptcy was prompted by an acute cash shortage. Prior to the bankruptcy filing, investors were aware of Lehman's increasing financial difficulties. However, use of financial statement "window-dressing" through off-balance sheet transactions, such as Repo 105, disguised the extent of the financial difficulties.

One can argue that had regulators and investors been informed of the true condition at Lehman Brothers, some of the problems in the financial crisis may have been averted. (The later bankruptcy filing by Lehman Brothers provided information on the repurchase transactions. Had Lehman Brothers not filed for bankruptcy, the accounting practices may have not been disclosed. Thus, we do not know the extent to which other investment firms used similar accounting treatments to window-dress financials.) Certainly, regulators would have had a clearer picture of the deteriorating financial condition at Lehman Brothers. Of particular concern to investors in Lehman Brothers were the leverage and the leverage ratio (Valukas, 2010, p. 800). The management at Lehman Brothers understood investors' concerns and in 2007 discussed the impact a deteriorating balance sheet and leverage condition would have on the company. The concern was that market declines and ratings downgrades would result if the financial condition were not improved (Valukas, 2010, p. 800).

With the implementation of a new accounting standard, Statement of Financial Accounting Standards (SFAS) 140, effective April, 2001, Lehman Brothers began using a tool to "manage" the balance sheet situation, repurchase agreements, Repo 105 and Repo 108 (Although Repo 105 and Repo 108 are technically different, this difference is in the amount of the cash inflow. The accounting treatment for each transaction is the same. For that reason, the article will refer both to Repo 105 and Repo 108 transactions as "Repo 105" in this. For Repo 105, fixed income bonds securities were used but for Repo 108, equities were used (Valukas, 2010, p. 732). As conditions at Lehman Brothers deteriorated, the firm increased its use of the Repo 105 agreements. Prior to the bankruptcy filing, in the 2nd quarter of 2008 SEC filing, Lehman Brothers had $50 billion in Repo 105 transactions not disclosed to investors. Clearly, the intention of management at Lehman Brothers in using Repo 105 transactions was initially to bolster the financial condition of the company in order to appease investors, and in later periods

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to avert bankruptcy. Despite the use of Repo 105, Lehman Brothers filed for bankruptcy with investors losing an estimated $46 billion in stock value.

The article is organized as follows:

1. First, there will be a discussion of the financial situation and events leading to Lehman Brothers bankruptcy and specifically how Repo 105 was used.
2. The article discusses the specific accounting, auditing, and factual requirements for the use of Repo 105 transactions; asset valuation under general accounting rules; and the usage of Repo 105 transactions at Lehman.
3. Finally, Repo 105 transactions are examined under specific laws: (1) the Securities Exchange Act of 1934, (2) Sarbanes-Oxley, and (3) the Private Securities Litigation Reform Act. Current cases and prior precedent are discussed.

Because of the complexity of Repo 105, we provide a short summary of the transactions and the accounting treatment at Lehman Brothers:

> A repo is a short term loan. Before quarterly and annual financial statements were filed, Lehman Brothers, which was in financial trouble, would make short term loans, using securities or equities as collateral. A "loophole" in GAAP (later changed) allowed Lehman Brothers to book this as a sale rather than a loan as long as Lehman put up at least 102% (of the value of the loan) in collateral. Lehman sometimes would put up 105% in securities or 108% in equities as collateral. Lehman would then use the "loan" money to buy down temporarily its debt, which reduced its leverage ratio (debt to equity), making the firm look less risky, and misleading analysts and investors. After the short term was up and the financial statements issued, Lehman would have to repay the loan with interest (the interest is thus a loss or "haircut"). Lehman did not acknowledge in SEC filings neither the amount of Repo 105 transactions nor the amount of debt that would shortly be repaid.

BACKGROUND: LEHMAN BROTHERS' FINANCIAL DIFFICULTIES: THE FINANCIAL CRISIS, AND FINANCIAL STATEMENT WINDOW-DRESSING—REPO 105

Lehman Brothers Financial Difficulties

Lehman Brothers was forced to file for bankruptcy in 2008. While Lehman filed for Chapter XI bankruptcy (usually meaning it might continue), the bankruptcy proceedings showed that the company needed to be liquidated and ended (as is usually the case under Chapter VII

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bankruptcy). Lehman Brothers, as a company, had the largest amount of assets for a firm filing for bankruptcy. At the time of the filing, it appeared that Lehman Brothers had $600 billion of assets with $30 billion in equity ("Lehman Brothers"). Months before the bankruptcy, Lehman Brothers' stock price had continued to fall.

By the weekend preceding the bankruptcy, Secretary of the Treasury Henry Paulson determined that Lehman Brothers had one of three options: (1) a purchase by another company, (2) a bailout (with no purchase) by other large investment and commercial banks, or (3) bankruptcy. One of the three had to occur before stock trading commenced the next week. The government determined that it did not have the legal authority to bail out an investment bank (although this could be done for a commercial bank). Yet, because of Lehman Brothers' enormous size and its connections throughout the U.S. and world economies, Paulson and Tim Geithner (head of the New York Federal Reserve bank) convened in secret with the heads of other large U.S. financial institutions. The fear was that Lehman Brothers' fall (coming after the fall of Bear Stearns) would trigger a cascading, free-falling economy (Paulson, 2010, p. 182-221).

During the weekend, the banks brought in their experts to examine Lehman Brothers' financials. They tried to value the assets and the tremendous amount of mortgage-related debt (While normally such financial dealings might seem dull, the BBC did both a movie and a documentary on that meeting ("The Last Days", 2009; "The Love of Money", 2009)). There was some concern among those present that assets might be over-valued.

One option was to bring in a buyer for Lehman Brothers. Paulson attempted to get Bank of America (BoA) to buy Lehman. But BoA was in no position to buy another troubled company, having recently purchased Countrywide, the largest of the non-bank mortgage companies. BoA appeared interested, but it eventually declined. The other potential purchaser was a large British bank, Barclay's. While Barclay's had a great interest in Lehman Brothers, the financial position of Lehman caused Britain's financial regulators to refuse to put one of its largest banks into harm's way (Paulson, 2010, p. 207-16).

The possible consortium of other U.S. banks reached the same conclusion. Investment of a considerable sum of money would be required to sustain Lehman Brothers. The consortium recognized both the riskiness of an investment in Lehman Brothers and the fall of Lehman Brothers would potentially result in other failures (Paulson, 2010, p. 187-221).

The world's largest stock trading company Merrill-Lynch was bought by BoA that weekend, but another tremendous blow was impending, and that was the fall of the largest insurer in the world—AIG. While AIG's regular insurance companies were doing reasonably well, AIG was not, selling around $80 billion dollars in credit default swaps, essentially insurance that one company would pay its loan back to another company. Most of these corporate borrowers were deeply in trouble with mortgage-related debt. This adversely affected AIG. Eventually the government would have to find a way to bail out both AIG and other banks through a program called TARP (Troubled Asset Relief Program) that would amount to

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hundreds of billions of dollars (Paulson, 2010, p. 322-401). Lehman Brothers filed for bankruptcy. The failures of Bear Stearns, Lehman Brothers, and AIG were signs that the economy and the stock market were headed toward the greatest recession since the Great Depression of the 1930s.

While Lehman Brothers' financial situation was desperate at the time of its bankruptcy filing, later investigations of its practices during the bankruptcy showed that through the use of Repo 105, the company was able to conceal a substantially worse financial condition. Through the use of Repo 105, Lehman Brothers had reduced the leverage ratio at the time when quarterly and yearly financial statements were reported by temporarily transferring investment assets with repurchase agreements, termed "Repo 105." Financial difficulties had been hidden from investors and regulators.

When the second quarter of 2008 financials were filed, Lehman had over $50 billion in Repo 105 transactions (Valukas, 2010, p. 919). In 2006, Lehman Brothers executives had suggested an appropriate cap on Repo 105 (exclusive of Repo 108 transactions) at $17 billion (Valukas, 2010, p. 921). This cap of $17 billion was approximately 1 x leverage. Yet, in the fourth quarter of 2008, the amount on the leverage position was nearly 3 times what Lehman Brothers executives had set as a limit.

The self-imposed cap was less than Lehman Brothers' external auditor suggested as being material. Conversely, the audit firm reported within the walkthrough papers that any item alone, or in the aggregate with one tenth of a point change in leverage was considered material (Valukas, 2010, p. 964). (The definition of material is of significant amount to impact the investor and potential investor's decision-making.) Therefore, the amounts under Repo 105 were material to the financial presentation. Indeed, the usage of the Repo 105 transactions, as attested by internal Lehman Brothers discussions, served no economic purpose other than to improve financial statements.

Financial Statement Window-Dressing

The intention of Lehman Brothers' management in using Repo 105 transactions was initially to bolster the financial condition of the company in order to appease investors and in later periods to avert bankruptcy. Corporations routinely engage in practices to improve financial condition through real activities manipulation, even though the practices are not expected to produce favorable economic benefits to the firm (Graham et al., 2004, p. 3). (An example of real activities manipulation is the payment of additional salesmen commissions at year end. In many cases, the salesman makes sales calls in December rather than in January, thereby not increasing overall sales.) The practices have been identified as a fourth quarter phenomenon with the implied intention of improving year-end financial condition. Lehman Brothers conducted Repo 105 transactions around quarterly and annual SEC filings.

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Corporations also structure transactions to fit accounting treatments. This practice is called "earnings management" and has been observed in acquisitions, leases, and issuance of convertible debt (Xu et al., 2007, p. 195). Again, these practices are apparent in U.S. corporations. Lehman Brothers structured the Repo 105 transactions in a way to permit a specific accounting treatment.

Thus, the Repo 105 transactions, in a sense, are examples of both earnings management and real activities manipulation, both documented phenomena. Lehman Brothers' management engaged in transactions that did not make long-term economic sense, costing the firm amounts in what was in effect, interest, and also structuring the transactions to avoid both collateralization treatment and asset impairment. Also, consistent with corporate practices, this is an indication of a firm engaging simultaneously in both transaction structuring and business activities to manage earnings (Lin et al., 2006).

In contrast to what might be expected in U.S. corporations, the examination of Lehman Brothers provides a rather extreme example where a firm's financial condition is so dire as to lead to bankruptcy and the reliance on the accounting treatment is seen as a means to continue the firm's existence. Two points can are made concerning the Lehman Brothers case. First, the accounting literature is not well developed in this area of measurement of the financial impact or magnitude of manipulations. The bankruptcy proceedings provide us with a means to quantify this in an identified firm. Second, because of the extreme nature of the activities, the obvious materiality of the Repo 105 transactions and documentation provided by the bankruptcy proceedings and court cases offer a prime example to examine the role of law in both earnings management and real activities manipulation. Our examination of Lehman Brothers is relevant and applicable to other corporations within the U.S. Thus, the article addresses the issue of whether Lehman Brothers' management violated legal statutes. In order to address the issue, the article examines accounting and auditing standards, the Securities Act of 1933, Securities Exchange Act of 1934, Sarbanes Oxley reporting requirements, and other laws.

Repo 105 Transactions

General Discussion

Repurchase agreements are typically short-term arrangements where the financial assets of an entity are transferred temporarily to another party in exchange for a cash transfer (which would, thus, normally be viewed as a short-term collateralized loan). The purpose of such arrangements is to provide for temporary liquidity. In effect, the transfer is a short-term borrowing, with the knowledge that the assets purchased will be later sold back to the original seller (hence, the term "repurchase") after a specific time period. For Lehman Brothers, one advantage of repurchase arrangements was the ability to use the cash inflow to reduce liabilities. As financial statement dates neared, Lehman Brothers would transfer assets for cash and use the

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cash to reduce debt, thereby improving the debt position of the company. The difficulty with this procedure was that accounting standards would *usually* require Lehman Brothers to acknowledge a liability if there was also an agreement to repurchase the assets at a later date (after financial statement presentation). Thus, the debt position would not be improved. This recording of a liability is required under collateralization (For example, if investment assets of $100,000 were converted to cash, the liquidity of the firm would improve. If the cash was then used to pay down debts, the debt to asset ratio would improve. However, if an agreement to repurchase (buy back) the same assets post financial statement date existed, then one accounting treatment would be to acknowledge a liability prior to financial statement date. Because the buy-back would include interest, the total amount of liability would be greater than the $100,000 received. (Though, at Lehman, the practice was loaded and termed a “haircut”.) Thus, repurchase transactions without a sale provision can have the potential to cause the debt to asset ratio to deteriorate. This accounting treatment would not have been beneficial to Lehman). Therefore, Lehman’s financial position, specifically cash and liquidity, could be improved using repurchase arrangements, only if Lehman was able to use the cash inflow from the arrangements without recording a liability. Thus, the repurchase arrangement needed to be recorded as a sale and not as a collateralization to meet accounting standards. A apparent loophole in GAAP appeared to provide such an opportunity.

Repurchase agreements (arrangements) are fairly common in investment banking. At Lehman, not all transactions were given the same accounting treatment. For example, in a “typical” repurchase arrangement, the firm would receive cash and record a liability. However, in a Repo 105 agreement, the asset was removed from the books in exchange for cash and there was no recording of a liability. In this article, this transaction is discussed as a “sale” transaction. The legal implications of a sale transaction will be discussed in the next section and later in the paper.

Ultimately, what Lehman Brothers accomplished through Repo 105 was not just to convert a debt transaction into a sale, but to lower the leverage ratio, a prominent number to investors and analysts. Leverage is typically defined as liabilities divided by shareholder equity (The report actually uses a slightly more complex definition of leverage: (total assets minus collateralized agreements) divided by stockholder’s equity. The collateralized agreements may have included some of the riskier mortgage-backed securities (Valukas, 2010, p. 752). The higher the leverage, the riskier a firm looks. Lehman would borrow money giving up collateral. When Lehman Brothers used the borrowed money temporarily to pay down its liabilities, the leverage ratio went down, making the firm look “less risky.” For example, according to the Valukas Report, in quarter 2, over $50 billion in Repo 105 money was used to reduce leverage from 13.9 to 12.1 (Valukas, 2010, p. 748). This was a large reduction in leverage.

At Lehman Brothers, the cash amount received was less than the total value of the assets. In some cases, the amount was 5% less (thus "Repo 105") and in others, the amount received was 8% less (Repo 108). In accounting terms, then the cash received was less than the asset

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value removed; therefore, the difference needed to be recorded somehow or the transaction would be "out of balance". This difference is referred to as the "haircut". Normal accounting handling of a sale transaction when less is received than the value of the asset is to record a loss. However, with transactions this large, the financial impact on the profit and loss statement of only 5% or 8% would not have been favorable. To avoid recording the loss, Lehman Brothers reasoned that since this amount would later be repaid, it should be recorded as a derivative (an asset).

Lehman Brothers used the cash received from "sale" of securities to pay down liabilities. With reduced liabilities, the financial condition appeared to have improved, however, the amount borrowed plus interest would need to be repaid at a later date. Thus, the transaction was only a temporary solution, providing improvement of financial condition for financial statement presentation purposes, when recorded as a Repo 105 transaction. The longer term perspective would be a deterioration of financial condition as the amount of the cash plus interest would then need to be repaid. The larger Repo 105 transactions were done in 2007 and 2008 though the practice initiated as early as fiscal 2001. Repo 105 transactions typically were initiated right before quarterly and annual financial statements with repayment in seven to ten days. After the seven to ten days, Lehman Brothers would have to undo the transaction by repaying the money and interest to the counter-party (Valukas, 2010, p. 732-33). According to the financial officer, there was "no substance" to the transactions other than to change the balance sheet (Valukas, 2010, p. 735). By the second quarter of 2008, the amount was over $50 billion dollars (Valukas, 2010, p. 742).

Sale Requirements under Repo 105

The accounting standard in place at the time Lehman used Repo 105, SFAS 140, appeared to allow this switch from a debt transaction to a sale transaction and the rule contained three main requirements to determine the nature of the transaction. If the three requirements were met, the transaction could be recorded as a "sale"; otherwise, the transaction would need to be recorded as a collateralization. As discussed above, to improve financial condition, the transaction needed to be recorded as a sale. These requirements can be summarized as: (1) isolation of the transferred asset from the transferor; (2) the transferee has rights to pledge or exchange the assets with "no condition (that-sic) both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor"; and (3) "the transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47,49) or the ability to unilaterally cause the holder to return specific assets…" (SFAS 140)

In order for control over the assets to have been relinquished, the transferor (here, Lehman Brothers) "must have both the contractual right and the contractual obligation to

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reacquire securities that are identical to or substantially the same as those concurrently transferred. The transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all the cost of purchasing identical replacement securities during the term of the contract" (SFAS 140). This standard essentially assumes that the similarity in value of the transfers between the parties is a determinate of whether a sale has occurred. If the transfers are very similar, a sale has likely not occurred, but if the transfers differ, then a sale has likely occurred (SFAS 140);

> The Board also decided that the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults. Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline. (SFAS 140)

If the value of the assets surrendered were similar, according to accounting standards, the transfer is deemed to be of a temporary nature. The accounting treatment would be collaterialization and not a sale. Thus, by structuring the contract in a certain way, Lehman Brothers was able to meet one of the provisions of the accounting standard for recording the transaction as a sale.

Paragraph 218 of SFAS 140 set the requirement at as much as 98% collateralization for entities agreeing to repurchase and as little as 102% overcollateralization for securities lenders. The interpretation of the standard (which is a part of GAAP) was that if it was between 98% and 102%, then this was close enough to being a transfer of similar assets to qualify as a collaterialization. Lehman Brothers set the amount at 105% (fixed income) or 108% (equity) in order to fall outside the limits, so that the repurchase was then accounted for as a sale. The quantification of the amounts in the accounting standards provided a means for parties to record the transaction as a sale or a collateralization, by setting the terms of the arrangement. An increase or decrease in transferred amounts by as little as 1% would trigger a different accounting treatment, provided the other conditions set forth in SFAS 140 were met.

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In order for it to be a sale, legally the transaction must be viewed as a sale. According to the Valukas bankruptcy report, legal counsel did not consider the transaction as a sale transaction (Valukas, 2010, p. 784). Indeed, Lehman Brothers was unable to find U.S. counsel that would support the transaction as a sale (Valukas, 2010, p. 784). Therefore, if the transaction were conducted within the U.S., U.S. commercial law would not be supportive of it being a sale transaction. Specifically, there existed an agreement to repurchase. However, Lehman Brothers contended that transactions between parties not within the U.S. could be accounted for using the law in existence for one of the parties. For example, if London law would identify the transaction as a sale, the transaction could be recorded as a sale on the books of the entity falling under London law. U.S. standards are silent on the issue of foreign law and this appears to be a very liberal interpretation of the standard.

As to whether the transaction was a "sale" or something else under the laws of the United States, securities law and even the Uniform Commercial Code as it relates to securities (Article 8 of the U.C.C.) are not particularly helpful because the term "sale" is so basic that it does not really need definition. By analogy, one can look to the U.C.C. Article 2 that deals with the sale of goods (recognizing, however, securities are not goods; goods here are moveable items in the form of personal property). U.C.C. section 2-106 says that a "'sale' consists in the passing of title from the seller to the buyer for a price." Title means the passage of ownership and would not normally be considered to be the transfer of collateral for money which for goods is governed by the law of secured transactions (Article 9 of the U.C.C.).

A secured transaction, which is governed by the U.C.C., is defined "as any transaction (*regardless of form*) which is intended to create a security interest" in collateral. Under Article 9, the collateral can be almost anything except real estate. The collateral under Article 9 explicitly includes securities (Uniform Commercial Code, § 9-105(i), 2001). The definition explicitly says that a secured transaction can exist "regardless of form."

(For example, so-called "leases" can be treated not as a true lease but a secured transaction if the "lessee" can acquire the leased items at the end of the lease for less than fair market value. Thus under Article 9, it is not the form but the substance (beyond the form) which designates it as a secured transaction and not a sale. In a secured transaction, the party giving up the right to repossess is known as the "debtor" and thus the transaction should then be regarded legally as debt (Uniform Commercial Code § 9-105(d), 2001). A debtor "owes payment or other performance of the obligation secured." (Uniform Commercial Code, § 9-105(d), 2001).

The term "secured" means that the debt is backed by collateral. Thus under United States law, it would be extremely difficult to call a Repo 105 transaction anything other than debt (or a secured debt); it is definitely not a "sale."

The major securities laws in the United States do not give a definition of the term "sale" but instead use it in creating other definitions. Thus, they seem to be relying on the same definition as found above.

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Black's Law Dictionary defines a "sale" as a "contract between two parties, respectively, the "seller" (or "vendor") and the "buyer" (or purchaser) by which the former, in consideration or promise of a certain price in money, transfers to the latter the title and possession of property" (Black, 1968, p. 1200). But the definition distinguishes sales from other transfers such as mortgages where collateral is involved. *Black's Law Dictionary* also defines "security agreement" as an "agreement which creates or provides for a security interest" which involves an "agreement granting a creditor a security interest in personal property" which is under Article 9 in the U.S. as a secured transaction (Black's Law Dictionary, 1968, p. 1217). A debt is also defined "as a sum of money due by certain and express agreement…"; a "secured debt" is one "secured by collateral" (Black, 1968, pp. 363-64). From this discussion, one can concur with the Valukas bankruptcy report. Had the transaction occurred in the U.S., it most certainly could not have been considered a sale.

Lehman Brothers responded to this specific provision of SFAS 140 by using a party that fell under London law, where the transaction would be viewed apparently as a sale. The party was a related party, Lehman Brothers International (LBIE). Some securities under Repo 105 agreements originated within LBIE and others originated with the U.S. Lehman entities, transferred to LBIE. In order for the sale to occur, the final party to the transaction had to be outside Lehman Brothers. Thus, Lehman Brothers structured transactions with unrelated parties, outside of the U.S., in order to avoid recording the transaction as a collateralization. If the recording of the transaction had been as a collateralization, as noted previously, the debt would have to be recognized prior to the financial statement preparation and there would have not been a favorable financial statement impact from the Repo 105 transactions. Lehman Brothers also used the "bright lines" provided by the accounting standards to structure the haircut in an amount exceeding the limits of SFAS 140 so that the transaction could be recorded as a sale.

Asset Valuation

Another consideration in SFAS 140 was the liquidity of assets. If a market did not exist for the assets, it would be difficult to value securities and apply the 5% or 8% provisions in the Repo 105 agreements, i.e., the buyer of the securities could not easily purchase similar securities, as provided under SFAS 140. The phrase, within Lehman's internal accounting policy on Repo 105 was "'readily obtainable' meaning 'a market must exist where the assets are either traded on a formal exchange or are considered liquid and trade in a market where price quotations either are published or are obtainable through another verifiable source'." (Valukas, 2010, p. 793). Although most of the securities in the Repo 105 arrangements appear to be governmental, which suggests liquidity, from 9% to 16% of the assets under Repo 105 may not have been (Valukas, 2010, p. 797). Whether a market existed for these securities is debatable. Clearly, the intention of Lehman Brothers was that the securities should be liquid, so as to be in compliance with the provision of SFAS 140.

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Although SFAS 140 provided a means to improve the cash situation of Lehman Brothers, if the sale were recorded according to the typical GAAP treatment of sales of assets, when the amount of cash received is less than the asset's book value, a loss should have been recorded. Lehman Brothers applied SFAS 133 (Statement of Financial Accounting Standard No. 133)R, recording the difference in value not as a loss, but as a financial asset, a derivative to reflect the amount of the "overcollateralization" in the Repo 105 arrangements. Thus, what would have been seen as a reduction to net income was shown as an increase in net assets. In the next accounting period, when the repurchase part of the transaction was concluded, the asset representing the "overcollateralization" would be removed. The striking fact of this aspect of the accounting treatment is that as noted above, Lehman argues the transaction is not a collateralization, but a sale and yet within the same transaction, argues the transaction is, indeed a collateralization, tied to the future transaction, when the securities will be repurchased. Yet, according to GAAP existing at the time, this was not a violation. That is to say, within one transaction, its handling could be a sale or a collateralization. This clearly contrasts with what the result would have been if U.S. law were applied, where the transaction would be identified as a collateralization (The co-author has not found any other transactions that can be divided into components with each component classified as a different type of transaction. The accounting standards generally give the circumstances by which a given transaction is classified—for example, in lease accounting. However, once the transaction is classified, each component part (account) is considered as falling under that classification. This "parceling out" within a journal entry is neither routine nor expected.).

Had Lehman Brothers not transferred assets through repurchase agreements, some assets would have certainly been seen as impaired. The accounting treatment for an impaired asset is to reduce the asset value and record a loss. If valued using fair value accounting, the value of the assets would have been reduced in line with market values. Depending on the nature of the investment, the accounting treatment would have resulted in either equity, other comprehensive income (OCI), or net income being negatively impacted. Lehman Brothers' use of Repo 105 transactions provided a means to "maintain" asset base (by transferring over-valued assets into cash) over what would have been had the assets remained on the balance sheet and not removed through repurchase agreements.

As the authors discuss later in the paper, neither Lehman Brothers' financial statements with related disclosures, nor the Management Discussion and Analysis section of the annual report (MD & A) discussed the accounting treatment of the Repo 105 transactions. Although the accounting for the transactions was complex, there was not disclosure within the SEC filings that would permit investors or regulators to evaluate the financial and economic impact.

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Usage of Repo 105 at Lehman

Statement of Financial Accounting Standards No. 140 (SFAS 140) became effective in April, 2001 (Financial Accounting Standards Board, 2010). Lehman Brothers began to use the standard in 2001 (Valukas, 2010, p. 765). Within the firm, there were conflicts concerning the usage of the accounting treatment. The accounting treatment of the Repo 105 agreements clearly improved the balance sheet performance of the firm, providing end of financial period "window dressing". However, within the firm, executives were leery of the equality of investments. Those securities subject to repurchase arrangements were separated from other securities not under repurchase arrangements in internal documents (Valukas, 2010, p. 811) and the term "sticky assets" was used to describe less valuable assets (Valukas, 2010, p. 805; Attributed to Clement Bernard). Bart McBade, the "balance sheet czar" within Lehman Brothers, supported limits on the usage of Repo 105 arrangements. Upon becoming President and Chief Operating Officer (COO) of Lehman Brothers on June 12, 2008, McBade authorized a proposal to reduce the firm's reliance on Repo 105 arrangements from $50 billion to $25 billion in the third quarter of 2008 (Valukas, 2010, p. 819).

The implication from internal memos circulated within Lehman Brothers was that the use of the Repo 105 arrangements served as a means to increase financial presentation but did not support other goals of the organization, namely economic growth. The use of the Repo 105 arrangements resulted in an increased expense to the organization, as interest on the borrowed funds was higher than that of other financing means and did not provide incentive for profitability (Valukas, 2010, p. 878). The Repo 105 arrangements were seen as a way to make balance sheet targets instead of improving financials through asset management. Thus, while the accounting effect was to improve reported financial condition, the economic impact was to deteriorate financial condition. The failure to disclose the nature of Repo 105 transactions within SEC filings did not inform investors of the negative impact on financial performance.

The argument presented by McBade in proposing limitations on the use of Repo 105 arrangements was that traders "should have sold inventory to reduce balance sheet, rather than engage in Repo 105 transactions." (Valukas, 2010, p. 815). Others suggested that growth and not the balance sheet should be the emphasis of operations.

In August 2007, assets under Repo 105 arrangements totaled $36.4 billion. In May 2008, assets under Repo 105 arrangements totaled $50.4 billion. The firm clearly increased its reliance on the arrangements in 2008.

Although Lehman Brothers appears to have been cognizant of the difficulties in over-reliance on Repo 105 agreements, the firm increasingly relied upon the accounting treatment to improve the appearance of the balance sheet. This is evidenced by emails within the organization, where executives suggested the cost of the Repo 105 arrangements was "irrelevant, we need to just do it" (Valukas, 2010, p. 865; attributed to Kaushik Amin, Head of Liquid Markets, of Lehman Brothers). Although the Repo 105 arrangements may have satisfied specific

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accounting standards, they did not make long term economic sense. In the end, Lehman's liquidity issues forced the firm into bankruptcy.

ACCOUNTING STANDARDS

Accounting Standards and Generally Accepted Accounting Principles

Within the US, accounting standards are generally provided by the Financial Accounting Standard Board (FASB). Although the Securities and Exchange Commission (SEC) remains the ultimate authority on financial accounting standards for publicly traded companies, the Commission generally defers the actual application of standards to FASB. In 2009, the FASB Accounting Standards Codification became the official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP) (FASB, 2012). The Codification did not change GAAP, but rather solidified pronouncements by FASB, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and others. The SEC guidance is also included within the Codification.

In the U.S., changes in accounting standards are established through a vetting process, where stakeholders are asked to comment on proposed changes. FASB has provided a conceptual framework (FASB, 2006). Specific accounting standards should be consistent with the conceptual framework. This framework suggests the over-riding objective, qualitative characteristic of financial information should be usefulness of decision-making. Additional primary characteristics are relevance (predictive value and confirmatory value) and faithful representation (completeness, neutrality, and free from material error). Additional enhancing characteristics are comparability, verifiability, timeliness, and understandability.

When the issue of Repo 105 agreements is considered within the FASB conceptual framework, there are a number of difficulties:

1. Relevance. Did the balance sheet presentation of cash when repurchase arrangements for less valuable assets existed provide predictive or confirmatory value?
2. Faithful representation. Was the information provided complete, neutral, and free from material error?
3. Did the balance sheet presentation provide for comparisons between Lehman at different points in time (given the increase in Repo 105 arrangements in later quarters)?
4. Did the balance sheet presentation provide for an understanding of the use of the Repo 105 arrangements and balance sheet impact?

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Overall, although the accounting for Repo 105 agreements appears to fail to support the fundamentals of accounting, as presented in the conceptual framework provided by FASB, the individual standards (GAAP) are supported. This is because the individual standards provided within the codification cannot provide for all the objectives. The specific guidelines established (such as the "haircut" provision of Repo 105) can be based on "bright lines". The development of specific accounting standards is a political process, and the industry and transactional complexities of accounting make it difficult to provide for absolute consistencies within the codification. Indeed, the SEC acknowledges that "short-term financing arrangements can present complex accounting and disclosure issues, even when market conditions are stable" (SEC, 2010).

The fundamental issue brought to light in the use of Repo 105 agreements by Lehman is whether an accounting system based on industry standards, applied in response to specific accounting transactions and events, can fulfill the objectives of financial reporting. Unlike the legal system where changes in law or interpretations of law are challenged and resolved in the courts, the operations of FASB do not always provide an adequate way to address inconsistencies. One reason may be that, unlike law, where injured parties challenge findings, prompts for changes in accounting treatment are sluggish. Thus, it took disclosures of the Repo arrangement to prompt both SEC and FASB to respond to the GAAP inadequacies.

At Lehman Brothers, company employees and external auditors appear to be the only parties aware of the accounting treatment of the Repo 105 transactions. Neither party (except for the whistleblower) disclosed the treatment to investors or regulators. Had Lehman Brothers not filed for bankruptcy, the Repo 105 transactions might not have been disclosed.

SEC Response to Inconsistencies and Inadequacies in Reporting

The SEC response to the disclosure inadequacies of the repurchase arrangements can be seen in a proposed rule on Short Term Borrowing Disclosure. The expanded reporting requirements would require a separate subsection with comprehensive explanations, including both qualitative and quantitative information (SEC, 2010). Ironically, the proposal is similar to reporting requirements for financial statements that were repealed in 1994. However, unlike the previous reporting requirements, the presentation is within the Management Discussion and Analysis (MD&A), which is part of a company annual SEC 10-K report where a "qualitative" and quantitative discussion is required. The implication of this is that accounting (ex-information included in the face of financial statements and disclosure notes) does not provide all necessary information to inform investors.

The specific changes proposed in the release, dated September 17, 2010 were as follows:

-the amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;

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-the average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings;
-for registrants meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period; and
-for all other registrants, the maximum month-end amount of each specified category short-term borrowings during the reporting period (SEC, 2011).

The purpose of the proposal was to inform investors of the fluctuations in short term borrowings so that investors can make informed judgments as to the amount of "window-dressing" in financials presented. The proposal was unanimously accepted by the board on January 28, 2011. In addition, the SEC issued a letter, dated March 2010, to "certain" public companies requesting information on repo arrangements (or similar arrangements) with the clear intent to reinforce the need to disclose such transactions with MD & A:

> …if you accounted for repurchase agreements, securities transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets as sales and did not provide disclosure of those transactions in your Management Discussion and Analysis, please advise us of the basis for your conclusion that disclosure was not necessary and describe the process you undertook to reach that conclusion (SEC, March 2010).

FASB Response to Inconsistencies and Inadequacies in Reporting

FASB also responded to the repurchase arrangements by replacing Statement of Financial Accounting Standard (SFAS 140)_with SFAS 166, effective September 2009 or January 2010. Within the Accounting Codification, changes also would preclude similar repurchase agreements from being accounted for as a sale. From the Accounting Codification 860-10-40-42, Repurchase Financings:

> A transferor and transferee shall not separately account for a transfer of a financial asset and a related repurchase financing unless both of the following conditions are met:
>
> a. The two transactions have a valid and distinct business or economic purpose for being entered into separately.
> b. The repurchase financing does not result in the initial transferor regaining control over the financial asset. (FASB, 2012).

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And the codification then specifically addresses the "window-dressing" issue:

> An example of transactions lacking a valid business or economic purpose for being entered into separately is if the transactions are structured to circumvent an accounting standard or solely to achieve a specific accounting result. Unless the initial transfer and the repurchase fTinancing meet all of the criteria in paragraph 860-10-40-44, the transaction shall be considered linked for purposes of applying this Topic" (FASB, 2010)

The difficulty with this new standard is that as indicated above, there are additional discussions in 860-10-40-44 that provide additional "holes" where standards could be circumvented. There is also some discussion among professionals as to whether the changes are enough to prevent a firm like Lehman Brothers from booking the same entries (Whitehouse, 2010).

Auditing Standards

General Discussion

Auditing standards within the U.S. for publicly traded companies, such as Lehman Brothers, are established by the Public Company Oversight Board (PCAOB) (Sarbanes-Oxley Act, 2006a). Prior to passage of the Sarbanes Oxley Act, auditing standards for publicly traded companies were set by the American Institute of Certified Public Accountants (AICPA). The PCAOB has accepted the AICPA auditing standards in the interim until auditing standards can be promulgated.

There are ten generally accepted auditing standards (GAAS) recognized in the U.S. The intent of the ten GAAS is to set a benchmark below which auditors should not perform. Courts have generally recognized the standard as a basis for performance (see below in Section IX). Auditors are required to follow the ten standards under the AICPA Code of Professional Conduct.

The first three standards, termed "General Standards", require the auditor to have adequate technical training and proficiency, independent mental attitude, and exercise professional care. The four "Standards of Fieldwork" require the auditor to plan work and supervise assistants, understand the entity and the environment, and obtain sufficient appropriate evidence. The four "Standards of Reporting" require the auditor to state in the audit report when financials are in accordance with GAAP, identify inconsistent application of GAAP between accounting periods, state when disclosures are inadequate, and express an opinion on the financial statements taken as a whole.

The Securities Exchange Act of 1934 requires financial statements and an auditor's opinion on annual filings (Securities Exchange Act, 2006a, 2006b). The end result of the audit is

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a publicly available document, termed the "audit report" that expresses the audit firm's opinion as to the financial statements. A standard clean or unqualified opinion is reserved for instances when: (1) all financial statements are included; (2) the three general standards have been followed; (3) sufficient appropriate evidence has been accumulated and the audit was conducted so that the fieldwork standards are met; (4) the financial statements are presented in accordance with GAAP, including footnotes and disclosures; and (5) no circumstances require the addition of an explanatory paragraph or modification to the report (Arens et al., 2012, p. 48).

The standard clean auditor's report contains the wording, "in our opinion, the financial statements referred to above present fairly, in all material aspects, the consolidated financial position of company at dates and the consolidated financial position of company at dates and the consolidated results of its operations and its cash flows for each of the n years in the period ended date, in conformity with U.S. generally accepted accounting principles". It is important to note here that the wording, "in conformity with U.S. generally accepted accounting principles" is a modifier to the phrase "present fairly". As noted in *Auditing and Assurance Services,* page 48, the term "present fairly" is one of most controversial parts of the auditor's report (Arens et al., 2012, p. 47).

Auditors are required to review the M D & A section of the annual report (the SEC's required (10-K) to see "whether it is materially consistent" with the information in their financial statements. (Statement on Auditing Standards (SAS 8.03)). (Technically, the Public Company Accounting Oversight Board (PCAOB) is responsible for establishing auditing standards for publicly traded companies; however, as an interim procedure, the PCAOB has accepted AICPA audit standards issued through April 16, 2003. The SEC has oversight over PCAOB and standards must be approved by the SEC.). A review of the M D & A is less stringent than an audit. However, according to PCAOB AT Section 701.107,

> if the practitioner concludes that the MD&A presentation contains material inconsistencies with other information included in the document containing the MD&A presentation or with the historical financial statements, material omissions, or material misstatements of fact, and management refuses to take corrective action, the practitioner should inform the audit committee or others with equivalent authority and responsibility. If the MD&A is not revised, the practitioner should evaluate (*a*) whether to resign from the engagement related to the MD&A, and (*b*) whether to remain as the entity's auditor or stand for re-election to audit the entity's financial statements. The practitioner may wish to consult with his or her attorney when making these evaluations. (PCAOB, 2003)

Therefore, if the M D & A contains material inconsistencies, at a minimum, the audit firm should inform the audit committee if the client refuses to take corrective action.

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Lehman Brothers Audit

Ernst & Young (E&Y) conducted the audit of Lehman Brothers for each of the three years ending on November 30, 2007, prior to the bankruptcy filing. Concerning the three general standards, E&Y appears in general to have met these standards. However, the Valukas report questions whether E&Y exercised "professional care" by failing to disclose Repo 105 practices to Lehman Brothers' audit committee. Complaints were made by Lehman top employees both to management and E&Y about the practice (Valukas, 2010, p. 956-57). One day after a complaint was made to E&Y, the auditor met with the Lehman Brothers' Audit Committee and did not raise the subject (Valukas, 2010, p. 959). The Valukas report discusses an accountant's duty to reveal fraud, material misrepresentations, and illegalities (Valukas, 2010, p. 1056). Therefore, whether E&Y was not correct in failing to inform the audit committee hinges on whether the client is believed to have committed fraud, material misrepresentations, and illegalities. The Valukas bankruptcy report suggests that the board of directors and outside disclosure counsel were unaware of the Repo 105 accounting usage and financial implications (Valukas, 2010, p. 855, 945).

Concerning the four standards of field work, E&Y was aware of the Repo 105 transactions and the accounting for the transactions. The auditor understood the accounting for Repo 105. According to the Valukas Report, the head of E&Y's audit group knew of Lehman's use of Repo 105 for years and stated while E&Y had not proposed the practice, they were "comfortable" with it (Valukas, 2010, p. 748-50). E&Y reviewed the documents showing Repo 105 but they were satisfied that they met with accounting standards (presumably the GAAP rule SFAS 140) (Valukas, 2010, p. 951, 953).

The four standards of reporting would require E&Y to identify consistent application of GAAP between periods. There is no indication that the Repo 105 transactions were handled differently in the accounting periods the auditors examined. However, given the previous discussion on accounting standards, the accounting for Repo 105 transactions is not consistent with other promulgated generally accepted accounting principles, such as not recording a loss on transfer and not recording liabilities when amounts are estimable and expected to be paid. According to GAAP, the disclosures related to the financials were adequate.

E&Y issued unqualified or clean audit reports prior to the bankruptcy filing. Had the standard wording of the audit report not included the phrase, "in conformity with U.S. generally accepted accounting principles", one might argue that the financials did not present fairly in all material aspects the financial position of the company. However, from the wording, it appears Lehman Brothers followed GAAP by structuring the transactions carefully within the existing provisions of accounting standards. Also, E&Y is required by auditing standards to not disclose proprietary information. (The exceptions to this general rule are not applicable to the Lehman

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Brothers analysis.) Generally accepted auditing standards did not require disclosures beyond that of GAAP and GAAP at the time did not require additional disclosures.

According to the SEC document, *A Beginner's Guide to Financial Statements,* provided to investors, significant accounting policies and practices that are "most important to the portrayal of the company's financial condition and results" should be disclosed in footnotes (SEC). The footnotes to Lehman Brothers' financial statement did not discuss specifically the accounting treatment for Repo 105. However, GAAP at the time did not provide guidance as to what information, if any, should be provided concerning Repo 105 transactions.

External auditors reviewing the transactions under the repurchase agreements might question the legality of the sale, however, external auditors are not legal authorities. In applying SFAS 140, external auditors are bound by AU Section 336, "Using the Work of a Specialist":

> The auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter (SFAS 140).

Included within AU Section 336 is a reference to legal questions. For example, auditors should consider using a specialist for "interpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property).

AICPA Rule 203

Audit firms fall under the guidance of the AICPA. As such, they are bound by the rules of professional conduct of the AICPA. Rule 203, in particular, is applicable to the E&Y audit of Lehman Brothers (AICPA, 1988). Rule 203 is consistent with the working of the standard auditor's report, that is, conformity with GAAP is lack of departure from accounting principles promulgated by authoritative bodies. However, the last sentence of Rule 203 is as follows:

> If, however, the statements or data contain such a departure and *the member can demonstrate* that due to unusual circumstances the financial statements or data would otherwise have been misleading the member *can comply* with the rule by describing the departure, its approximate effects, if practicable,

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> and the reasons why compliance with the principle would result in a misleading statement.(Rule 203, AICPA, 1988)

We have added the italics to emphasize that the auditor is not required to disclose or to depart from promulgated GAAP if the financials are misleading but that the auditor can do so and would do so under unusual circumstances. The auditor is not required under Rule 203 to require changes to the financials even if they may be misleading. The AICPA further clarified Rule 203 in an interpretation:

> There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.
>
> However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.
>
> The question of what constitutes unusual circumstances, as referred to in Rule 203 [sec. 203 par. 01] is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle within GAAP would be regarded generally by reasonable persons as producing misleading financial statements. (Rule 203 par. 02).

Thus, while the interpretation seemed to put more responsibility on the auditor, in the end, it is a matter of professional judgment. To summarize, then, E&Y would have to have had a compelling belief that the financials were materially misleading and then would have had to choose to require Lehman Brothers' to correct the financials (or issue something other than the standard unqualified audit opinion). The rule assumes that in nearly all instances, GAAP should be adequate. The rule seems to put the burden on E&Y to show that following GAAP would have created misleading financials by stating that in almost all circumstances the presumption is that the promulgated GAAP would not be misleading. E&Y is permitted professional judgment in this decision.

Rule 203 is more frequently used when the auditor’s clients depart from promulgated GAAP. Then, auditors can issue an unqualified audit report but add a paragraph to describe the client's departure from GAAP.

Presumably, E&Y did not find "the literal application of pronouncements in accounting principles" to "have the effect of rendering the financial statements misleading". To prove that

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E&Y did not abide by Rule 203 would require questioning the professional judgment of the auditor. Given there are no indications that the minimum standards (except for the reference to "professional care" alluded to above) were not met, this would be difficult to establish. But if there were legal red flags, auditors would normally seek legal counsel.

FEDERAL SECURITIES AND ACCOUNTING LAWS

The Securities Exchange Act of 1934

A clear distinction can be made between the GAAP standards (as they then existed) and the federal securities law and this is where the conflict arises; the accountants have their standards but they may occasionally run into difficulties with the law. The Securities Exchange Act of 1934 deals primarily with ongoing problems in securities markets while the Securities Act of 1933 deals primarily with the registration of securities. The former law is the one that would apply to the present facts. Under the Securities Exchange Act of 1934 there are two provisions that appear to be relevant: (1) Section 78j which relates "Manipulative and Deceptive Devices" or more commonly known as fraud (The Securities Exchange Act of 1934, 2006a) and (2) Section 78m which deals with periodic reporting (The Securities Exchange Act of 1934 (2006b). Since the reporting by Lehman Brothers dealt with their quarterly and yearly financial statements under (2), that section would be relevant. But also since these quarterly and yearly financial statements are used by investor and investment advisor, they may also be "deceptive" or perhaps fraudulent.

Periodic Reporting

The 1934 law requires companies that have $10 million in assets and 500 shareholders, companies that are traded on national stock exchanges, or those that have made registered offerings under the 1933 Act to file annual report (10-K), quarterly reports (10-Q), and form 8-K when material events occur (Securities Exchange Act of 1934, 2006b).

These reports required by the 1934 law are different than the glossy reports that shareholders typically get from corporations. But false or misleading reports under the 1934 law are illegal and impose liability for any party involved in the filing (Securities Exchange Act of 1934 (2006c)). An implied provision for civil damages has been allowed by the courts for private parties (Herman & MacLean v. Huddleston, 459 U.S. 375, 383 (1983)). If, as it appears, Lehman Brothers was knowingly (through false statements or omissions) manipulating its quarterly and yearly statements by Repo 105 to show lower leverage just before they were issued, the 1934 law would appear to have been violated. Given the circumstances of the actions, specifically the unusual actions of trying to convert liabilities to assets for just a few days when the statements would be issued and the need to get a legal opinion on what a "sale" is

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outside of the United States, it could readily be inferred that the statements were known to be misleading. In fact, such transactions were the kind that the two possible buyers of Lehman, Bank of America and Barclay's, were fearful of: that Lehman Brothers' financial situation was much worse than it appeared on the surface. That Lehman Brothers went to such elaborate lengths to make its statements look better for such a brief period of time when it was required to issue the statements under the 1934 law, would seem to indicate that a defense of lack of knowledge would be likely to fail. The reporting requirements not only include financial statements, but also they have several parts where risk factors are to be discussed (Title 17: Commodity and Securities Exchanges, 2011a). It would seem that the use of Repo 105, which appeared to hide risky assets, would need to be disclosed.

The penalties for violation of the law are substantial. Depending on the type of violation, criminal and civil penalties can be quite substantial if knowingly done. For example, for knowingly and willingly issuing false periodic financial statements can result in fines up to $5 million and up to 20 years in prison (Sarbanes-Oxley, 2006b).

The 1934's Antifraud Provision (sec. 10b)

Almost all fraud cases brought by the government or by private parties are brought under the Securities Exchange Act's provision Section 10b (Securities Exchange Act (2006c). This section is interpreted by the SEC through its Regulation 10(b)-5. This provision prohibits in regard to nationally traded securities "(a) to employ any device, scheme, or artifice to defraud, (b) "to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase of sale of securities." (Title 17: Commodity and Securities Exchanges, 2011b).

One of the factors that cause section 10(b) to differ from common law fraud is that omissions can count as fraud just as much as deceitful statements can. The misstatements or omissions do have to be material—that is, likely to have an impact on the price of the securities. Like common law fraud, the prosecutor does have to prove "scienter"—that is, the statement or omission was made knowingly or with reckless disregard for the truth. Mere negligence (without scienter) is not enough show fraud under 10b-5 (Holdsworth v. Strong, 1976).

Private parties have an implied right to sue for fraud under Section 10(b) (Herman & McClean v. Huddleston, 1985; Wachovia bank & Trust Co. v. Nat'l Student Marketing Corp., 1980). As plaintiffs, they must be purchasers or sellers of the securities and must have relied on the statements or omissions (Blue Chip Stamps v. Manor Drug Stores, 1975); if the government is the prosecutor or plaintiff, it is not subject to showing these preceding elements. Privity (or a contractual relationship with the defendant) is not required (Superintendant of Insurance v. Bankers Life & Casualty Co., 1971).

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Also, some courts have ruled that private plaintiffs have shown reliance merely by the availability of the securities in the marketplace, because the misstatements or omissions may have affected the price. This is known as the "fraud-on-the market" theory. The idea is that the market is acting as an agent of the investor and thus is giving information to the investor. Thus, under this theory, direct reliance is not necessary. This theory is supported by the U.S. Supreme Court *(*Basic, Inc. v. Levinson,1988; Blackie v. Barrack, 1975).

Those who aid and abet the violation of section 10(b) are also liable if the party knew of the violation and gave substantial assistance to the violator (Sarbanes-Oxley Act (2006c)). The statute of limitations for private right cases (which was lengthened by Sarbanes-Oxley) is two years after the discovery of the facts or five years from when the violation occurred (Sarbanes-Oxley Act (2006d)). Violation of the law involves both civil liability to private parties and the SEC and also potential criminal penalties of up to $5 million per violation and up to 20 years in prison. Corporations can be liable under criminal law for up to $25 million (Sarbanes-Oxley Act (2006e)).

State securities laws have similar provisions and, since the major exchanges are in New York City, it is not unusual for the State of New York (sometimes in connection with other states) to bring action against securities violators (New York v. Ernst & Young, 2010).

We considered whether the Repo 105 accounting treatment violated section 10-b. Clearly the accounting treatment made Lehman falsely look better, altering liabilities, temporarily increasing cash, and resulting in lower leverage ratios. This undoubtedly kept the Lehman Brothers' stock price from falling faster than it eventually did, postponing the bankruptcy filing. Lehman Brothers' executives thought that it might buy them time to stay out of bankruptcy, to get a government bailout, or to be bought by another company (such as BoA or Barclay's). Keeping the stock price higher also undoubtedly helped Lehman Brothers' executives who owned stock in the company and who possibly had stock options. Lehman Brothers' executives referred to the increasing use of Repo 105 as a "drug," "window dressing," and an "accounting gimmick." (Valukas, 2010, p. 869).

Was there "scienter" on the part of Lehman Brothers, the Lehman Brothers' executives, E&Y and the lawyers? "Scienter" refers to whether the misrepresentations were knowingly done (or sometimes done with reckless disregard for the truth). There are several factors here, any of which indicates that what they did was misleading and that they knew it. First, the timing suggests it. The Repo 105 was scheduled to occur right before their quarterly and yearly financial statements (Valukas, 2010, p. 733). The repurchase had to be undone quickly, right after the statements came out. Second, according to the bankruptcy examiner, they couldn't find accountants and lawyers to sign off on the deal in the United States. So Lehman had to go to London to find accountants and lawyers (Valukas, 2010, p. 740). This suggests that the Lehman executives were shopping for someone to sign off on the financials, thus ignoring the misleading nature of their practices. Various statements, emails, and other documents suggest that the company knew exactly what they were doing. According to Global Financial Controller Martin

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Kelly, "the only purpose or motive for the transaction was reduction in balance sheet" and "there was no substance to the transactions." (Valukas, 2010, p. 735). He also said that "if there was more transparency to people around the transactions, it would present a dim picture" of Lehman (Valukas, 2010, p. 886).

Also, the Valukas Report (realizing it is not the last word since a trial has not occurred and counter-evidence has not been produced) seems to be damning. First, the facts themselves are more than suspicious. Using an unusual accounting treatment before quarterly and yearly financial statements were issued and going to London when no U.S. lawyer could be convinced to call it a "sale" rather than a secured loan are indications that the firm was less than forthright. According to the Valukas report, the only reason for the usage of Repo 105 agreements was to make the balance sheet more appealing even though the transactions would be undone in a few days. Lehman Brothers' executives believed that Standard and Poors put a high value on the leverage ratio in regard to rating the firm. Dick Fuld ordered system wide deleveraging; given the assets that Lehman had, Repo 105 appeared to be the only means possible (Valukas, 2010, p. 735-36). Lehman Brothers did it to win back investors by restoring confidence (Valukas, 2010, p. 737). The CFO tells analysts that the balance sheet was made to look transparent while hiding the use of Repo 105 (Valukas, 2010, p. 739).

Lehman Brothers attempted to reign in the use of Repo 105 by setting quarterly limits, and yet every quarter they went over the limit (Valukas, 2010, p. 741). The COO referred to the practice in an email "as the drug we r on (sic)." (Valukas, 2010, p.742). The employees referred to it as an "accounting gimmick" and "window dressing." As time went on and as the situation worsened, Lehman Brothers increased its use quarter by quarter to up to $50 billion, and still the executives felt more and more desperate and thus they needed to expand its use (Valukas, 2010, p. 745-46). E&Y regarded moving the leverage ratio one tenth of 1 point as material. The use of Repo 105 moved the leverage ratio down by several points (Valukas, 2010, p. 747). Thus, the Valukas Report concluded that the financial statements were certainly "materially misleading." (Valukas, 2010, p. 747). All of this is backed by not only the facts, but by statements made to Valukas investigators and in numerous Lehman e-mails, documents, and plans.

If E&Y were involved, it would seem that they would be involved in more than "aiding and abetting" the scheme, since they would have been involved with certifying the financial statements (particularly the 10-K's) and appeared to know of the practice (The Supreme Court has ruled that merely "aiding and abetting" in not sufficient for private parties to sue under Securities Law under sec. 10(b) (Stoneridge Investment Partners, LLC v. Scientific-Atlanta (2008)). But additional parties could be apparently liable if all of the elements of a basic 10-b case are present. These include a material misrepresentation or omission, scienter, purchase or sale, reliance, loss, and causation. *Id.* But it would appear Ernst & Young, by issuing 10-Q's and 10-K's, could indeed have misrepresented or omitted material facts and that investors could have relied on these documents. That, of course, would depend on the specific facts (Wilkes, 2010). Even if the practice technically was appropriate under GAAP, the resulting financials

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would be misleading. Liability would exist for all of the parties. Again "scienter" would have to be proven in order for E&Y to be liable. E&Y denied that they instigated the practice, but it is clear from the facts of the bankruptcy examiner that E&Y did know that the practice was being used (particularly after they were told by Lehman executive Matthew Lee) and yet they issued clean audit reports (Valukas, 2010, p. 956-58).

Part of the yearly 10-K is a required statement of "Management Discussion of Analysis"(MD&A). In the SEC's rule S-K, section 303, the purpose of the MD&A is "to provide investors and other users information relevant to an assessment of the financial condition and results of operations of the registrant, as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources." (Title 17: Commodity and Securities Exchanges, 2011c). Thus, a narrative is required because the numerical nature of the financials may not be adequate for "an investor to judge the quality of earnings" and to judge the "short- and long-term analysis of the business of the company." The intent of the MD&A discussion is to provide "a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present." (SEC, 2012a)

Certainly, the amount of transactions under Repo 105 and the positive effect on financial ratios would have affected investors' opinions about the long term situation, and indeed, the solvency of Lehman Brothers. Clearly, given the internal management discussion of the Repo 105 agreements (as documented in the bankruptcy filing), their importance in operations, and impact on financials should have been discussed in order to provide investors with an understanding of management's view of operations. In addition to those objectives previously discussed, the MD&A is intended to "provide the context within which financial information should be analyzed" (SEC, 2012a). Without the inclusion of a discussion of Repo 105 transactions, investors would not have known the impact the transactions were having on financials. Likewise, within this interpretation, the SEC defines addition information to include in the Management Discussion and Analysis: "companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance…" (SEC, 2012b). Given the usage of the Repo 105 agreements within Lehman, the importance of the agreements in meeting certain financial performance goals, and the material significance of the agreements, clearly the Management Discussion and Analysis should have addressed the usage of Repo agreements and the financial impact of the agreements.

The standard instructions for Filing Forms, Regulation S-K, say:

> Liquidity. Indentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the

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> registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets (SEC, 2012c).

The Repo 105 agreements did result in material changes in liquidity and were an internal/external source of liquidity by temporarily transferring assets to cash. Therefore, failure to discuss the Repo 105 agreements was a clear violation of the filing requirements. In addition, paragraph 4, also of item 4, discusses the reporting requirements under M D & A for off-balance sheet arrangements and lists specific items that Lehman should have disclosed. At a minimum, then, Lehman Brothers should have disclosed the business purposes of the arrangement: to improve the financial presentation of the entity given the importance in terms of liquidity and the amounts of cash flows and expenses associated with the arrangements.

Section 303(a)(4) requires the MD&A to discuss "off-balance-sheet" arrangements that are likely to affect the financial condition of the company. Included are interests "in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support to such entity for such assets" (SEC, 2012c). Indeed, Repo 105 was in effect a loan backed by questionable assets (usually U.S. securities for Repo 105 or equities for Repo 108) (Valukas, 2010, p. 732). Thus, it was both a loan or credit involving third parties (thus unconsolidated) and also one that apparently indicated higher liquidity and/or market risk support since it caused its leverage ratio to be improved.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOX) has largely been embedded into the Securities Exchange Act of 1934 (which, of course, has been amended many times).The law requires increased disclosure of "off-balance" transactions, such as Repo 105 transactions that were not disclosed by Lehman Brothers (Sarbanes-Oxley Act (2006f). The law also requires that "critical" accounting policies be reported from auditors to the audit committees. The authors are unable to find evidence suggesting that the practice was reported to the audit committee. The Valukas report suggests that the board of directors was not informed of the Repo 105 financial impact (Valukas, 2010, p. 1019).

Furthermore, CEOs and CFOs are required to sign off that the information "fairly represents in all material respects the financial conditions and results of operations" (Sarbanes-Oxley Act, 2006g). They are to review the report and to make sure that it does not contain any untrue statements or omissions of material facts and that internal controls are in place. Management can be liable if they certify knowing it is false or if they have not instituted internal controls to catch the problem. In this case there may be parties who could liable because they may have been knowingly at fault. This carries a criminal penalty of a fine of up to $1 million and up to 10 years in jail. If the false certifications were done knowingly and willfully, the

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penalty increases to $5 million and up to 20 years in jail (Sarbanes-Oxley Act 2006b). These, of course, are for each violation.

The Private Securities Litigation and Reform Act

The main purpose of the Private Securities Litigation and Reform Act (PSLRA) is to protect management, and in general, limit class action lawsuits against auditors and management particularly for forward looking financial statements. The law makes it difficult to make a prima facie case against management and auditors and limits liability based on percentage fault rather than allowing, perhaps, one party to take the entire loss (to stop joint and several liability). Another aspect of the law is to keep auditing firms from taking the entire loss if a company fails.

However, the law does have a large exception: the auditors, for example, can have joint and several liability if the defendants knowingly caused harm (Private Securities Litigation and Reform Act (2006a)). The bankruptcy examiner's evidence, if it is accurate, seems to indicate that scienter existed all around from top management to the auditors. It is interesting that the Valukas is reluctant to use the term "fraud," since the evidence that they gathered contains more than enough "smoking guns" in terms of evidence in the form of e-mails, documents, and testimony to show that "scienter" did exist.

The Private Securities Litigation and Reform Act was intended to give some protection to management and auditors. It also imposed some specific requirements on auditors. Auditors are required specifically to implement procedures to (1) detect material illegal activity, (2) identify material related-party transactions, and (3) evaluate a company's ability to continue as a going concern (Private Securities Litigation and Reform Act (2006b)).

Certainly it might appear that illegal activity was occurring by hiding liabilities in the form of sales through the use of Repo 105. In addition, the use of Repo 105 did affect investors' and analysts' view of Lehman Brothers. By changing the leverage ratio, it appeared that Lehman was doing much better than some believed—at a time when stock price was declining. In reality, Lehman's ability to continue as a "going concern" was questionable.

Furthermore, the law requires that the auditors must report such activity to the audit committee or the board of directors. The Board has one day to fix the problem and if the Board does not, the auditors are required to report the activity to the SEC or to resign (Private Securities (2006b)). Apparently, according to the Valukas Report, neither happened, though undoubtedly top management and eventually the auditors did know and use the apparently illegal practices.

One of the results of this law and recent cases is that it is more difficult for class action plaintiffs to succeed in regard to securities and other class action lawsuits. More and more of these cases are thrown out unless the pleadings are much more specific and show a plausible case against the defendant(s) (Ashcroft v. Iqbal (2009) and Bell Atlantic Corp. v. Twombly (2007); Craiger (2011), Cook (2006)). Lawsuits can be dismissed without the discovery necessary to add the detail required to survive a motion to dismissal. However, lawsuits against Lehman Brothers' executives and E&Y may be able to overcome these difficulties because of the specific facts uncovered in the Valukas report.

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Current Lawsuits against Lehman Executives and Ernst & Young

As was mentioned earlier, there are still no SEC actions relating to Lehman Brothers executives or accountants. It is possible that the SEC is waiting for the bankruptcy judge to hold a hearing to determine the validity of the Valukas Report. The SEC may be continuing to study the massive amounts of evidence ("SEC says," 2012). Perhaps, they will do nothing, although the evidence so far seems overwhelming.

New York State has brought legal actions against E&Y for the Repo 105 transactions claiming that the practice was a manipulation of the firm's balance sheet (New York v. Ernst & Young, 2010). According to one news report, there could be both civil and criminal charges filed against E&Y (Lattman & Craig, 2010; Blackden, 2010). A civil complaint was filed in December of 2010 (New York v. Ernst & Young, 2010). The case started with a New York court, then was moved to federal court, and then back to New York. The case was moved from state to federal court since some apparently possible federal law was involved besides the state law. But later the federal court said the case brought by New York state could be tried exclusively under New York state law. It also concluded that the federal courts had no jurisdiction over this New York state law claim and thus sent it back to the state court (In re Lehman Bros. Securities and ERISA Litigation, 2012a).

However, a separate case involving private parties was brought in federal court (consolidated before the same federal judge) which involved not only the auditors, but also Lehman executives, underwriters, and UBS. In a motion to dismiss (before trial), the federal judge was not inclined to let the parties off the hook on all counts. The federal judge wrote a lengthy opinion on the motion to dismiss, much of which dealt with Repo 105:

> The suggestions that defendants believed that the Repo 105 transactions were permissible in and of themselves and that the financial reporting for them, in and of itself, complied with GAAP does not address the core of plaintiffs' claims — that they were used to reduce temporarily and artificially Lehman's net leverage and paint a misleading picture of the company's financial position at the end of each quarter. The allegations that these transactions were used at the end of each reporting period, in amounts that increased as the economic crisis intensified, to affect a financial metric that allegedly was material to investors, credit rating agencies, and analysts support a strong inference that the Insider Defendants knew, or were reckless in not knowing, that use of the Repo 105 transactions and the manner in which they were accounted for painted a misleading picture of the company's finances (In re: Lehman Bros. Securities and ERISA Litigation, 2011).

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As to E&Y, the judge dismissed some counts but not those for the statements issued by E&Y after the meeting with Lehman whistleblower Matthew Lee.

However, in May 2012, a U.S. District Court approved a class action settlement against the Lehman executives. The amount was $90 million, which was paid from insurance policy. District Judge Kaplan expressed concern about not going after the personal assets of the Lehman executives but eventually approved the settlement, given the inherent risks of going to trial (In re: Lehman Brothers Securities and ERISA Litigation, 2012b). There is also a $426 million settlement, not yet approved, with the underwriters. The case against UBS and E&Y is still pending.

Accounting regulators in Britain are also looking at E&Y's practices over Repo 105 (Kennedy, 2010). The SEC has not taken action against E&Y.

Legal Cases Involving Conflicts Between GAAP and Law

While there are many cases involving fraud and misleading statements under securities law, the United State Supreme Court has not directly addressed a conflict between GAAP and potentially false and misleading statements. However, a number of Circuit Court cases deal with the issue. One of the seminal cases was decided in 1969, United States v. Simon (United States v. Simon, 1969; S.E.C. v. Arthur Young & Co., 1979). The case involved a misleading audit from an accounting firm in violation of the Securities Exchange Act of 1934 (United States v. Simon, 1969, p. 798). According to the court:

> Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then, as the Lybrand firm stated in its letter accepting the Continental engagement, he must 'extend his procedures to determine whether or not such suspicions are justified.' If as a result of such an extension or, as here, without it, he finds his suspicions to be confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established. At least this must be true when the dishonesty he has discovered is not some minor peccadillo but a diversion so large as to imperil if not destroy the very solvency of the enterprise (United States v. Simon, 1969, p. 806-07).

The defendant called eight expert accountants who testified that the financial statements were in accordance with GAAP and thus constituted "fair presentation." (United States v. Simon, 1969, p. 805). The defendants asked for jury instructions at trial that said the defendants should win the case if the accountants followed GAAP (United States v. Simon, 1969, p. 805). The trial

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judge refused to do so, and the Circuit Court said this was proper and the jury could find that accountants knowingly misled (United States v. Simon, 1969, p. 806).

More recent cases confirm the resolution of this conflict. . In a 2006, Court of Appeals case United States v. Rigas, the court found: "…GAAP neither establishes nor shields guilt in a securities fraud case." (United States v. Rigas, p. 220).

A recent finding in United States v. Ebbers (the CEO of WorldComm), a case cited *In re* Lehman Bros. Equity/Debt Securities Litigation, the opinion states:

"The rules [GAAP] are no shield, however, in a case such as the present one, where the evidence showed that accounting methods known to be misleading—although perhaps at times fortuitously in compliance with particular GAAP rules—were used for the express purpose of intentionally misstating WorldCom's financial position…"(United States v. Ebbers, 2006). Furthermore, the court said,

> However, even where improper accounting is alleged, the statute requires proof only of intentionally misleading statements that are material, i.e., designed to affect the price of a security. 15 U.S.C. §78ff. If the government proves that a defendant was responsible for financial reports that intentionally and materially misled investors, the statute is satisfied. The government is not required in addition to prevail in a battle of expert witnesses over the application of individual GAAP rules (United States v. Ebbers, 2006).

CONCLUSION

The Lehman Repo 105 situation is still playing out in court. The Valukas Report appears to have been meticulously done, but Lehman and Ernst & Young will be able to have their day not only in bankruptcy court, but also in civil court and quite possibly in criminal court, should the SEC send charges to the Department of Justice.

There is a lot of discussion as to why the S.E.C. has yet to move against Lehman Brothers executives and auditors. Certainly the firm itself is bankrupt, but its officers and its auditor, E & Y, could still be candidates for charges, civil or criminal. The facts are daunting in their complexity and proving liability before a jury would be difficult. The accounting standards that Lehman Brothers used, while open to misuse, are difficult at best to explain. Still, it would seem to be surprising if Lehman Brothers' executives and Ernst & Young would be left untouched by SEC. But given the length of time that has gone by, it is possible that the SEC is embarrassed that the scheme got so far.

The bankruptcy examiner's report is full of documents and emails that show that Lehman Brothers' executives knew precisely what they were doing and the purpose of the transactions. That these transactions occurred right before quarterly and annual statements would be enough evidence. That the transactions had to be moved from the United States to the U.K. to get a law

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firm to sign off on them as a sale rather than debt is another significant fact. Lehman Brothers also had actual documents on how they were to do these transactions with some limits (some of which were violated). These limits seemed to say, "we want to mislead but maybe there is a limit on how far we are willing to go." But eventually, even these limits were ignored.

Does all of this seem somewhat reminiscent of Enron? Certainly, the multitude of different types of Enron schemes seem to dwarf the Lehman Brothers' situation. Enron was not only "cooking" their books but also involved in massive schemes to monopolize parts of the energy sector, thus driving, for example, the price of California electricity through the roof (McLean & Elkind, 2004). On the other hand, the fall of Lehman Brothers, the largest U.S. bankruptcy ever, had a much greater impact on the economy.

The passage of Sarbanes-Oxley was designed to stop these types of practices. But in spite of the law, Lehman happened anyway. One could respond by saying that increasing the requirements and penalties will never stop the "bad guys" from violating the law. While this is true, it raises the question (which is hardly new) whether there are fundamental problems in relying upon detailed accounting standards.

Generally Accepted Accounting Principles (GAAP) is rule-based. However, if companies find a way to "game" the rules, they may well be tempted to do so. The only reference we find to an overriding accounting rule over GAAP is the AICPA Rule 203 (discussed above) that allows possible departure from GAAP if following GAAP would be misleading. While auditing standards rely on GAAP, federal laws—the Securities Exchange Act of 1934, Sarbanes-Oxley, and the Private Securities Litigation Reform Act—provide some support that GAAP in unusual circumstances may not be the final word.

One approach to resolving the differences between GAAP and the law, then, might be to have an overarching rule in GAAP that says that all other rules are subordinate to showing in the statements the true financial condition of the company. External auditors benefit from accounting rules with "bright lines", it makes their jobs easier to find misstatements without additional steps in interpreting standards. It is unlikely that the accounting profession would be supportive of this change.

Toba suggests that presenting fairly the financial condition of a company should be approached using a conditional approach. First, it is necessary to know what the proposition, "presenting fairly" means. Second, the determination of a way to verify should be established. Lastly, there must be a collection of evidence (Toba, 1980). This approach suggests then that the auditor would first accept the legal definitions of "present fairly" and then proceed with the audit.

It is beyond the scope of this article and the ability of the authors to suggest a workable alternative to the present system. This issue has long been a concern to the profession. In 1972, J.C. Burton observed, "by writing precise rules the Board (sic—APB Board) made it possible for people to observe the letter and avoid the spirit of the blessing—and often with the assistance of their auditors". (Stewart, 1986).

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The setting of accounting standards is dynamic and the Lehman Brothers case, Repo 105, is an example of this. As put quite succinctly by Steward, “repeated attempts to logically derive accounting standards from a set of objectives and definitions overlook that standards depend not only on premises, but also on moves made in response to them, counter to them, and so on” (Stewart, 1986, p. 406).

In the Lehman Repo 105 case we present, the accounting practice was initiated in 2001. SFAS 166, that removed loopholes in GAAP exploited by Lehman Brothers, became effective in 2010. Additional SEC reporting requirements to address window-dressing were proposed in 2010 and unanimously accepted by the board in 2011. Thus, Lehman Brothers was able to use Repo 105 transactions to adjust financial results for many years before either FASB or the SEC made adjustments.

The amounts placed in Repo 105 transactions in early 2001 may not have been considered material in the examination of what constitutes fair presentation of financials; however, at the time of Lehman Brother’s bankruptcy filing in 2008, the accounting effect from the Repo 105 transactions did materially improve the financial presentation. Lehman Brothers would not have entered the agreements, except for the expected positive impact on their financial condition and investor reactions, as the transactions did not have economic substance.

Still, even if GAAP inconsistencies are somehow fixed, there remains an even more fundamental question. The problem is the inconsistency between the auditing standards and the securities law. One could argue that the auditors should have been alerted to the potential that the financials were not presented fairly; in other words, the sale opinion and netting grid should have been “red flags” under auditing standards. On the other side, under current auditing standards, the auditors were not found to be in violation of standards of fieldwork. The question really is one of determining what the auditor’s responsibility for an examination of financial statements is. Is the auditor responsible for interpretation of the financial statements and understanding what “the reasonable man” would conclude or should the auditor rely on the pronouncements of authoritative bodies and the standard setting bodies to determine compliance? Auditing standards suggest reliance on the promulgations from authoritative bodies while securities laws may in rare circumstances suggest otherwise. One could also argue that since GAAP is backed by not only the AICPA, but also the government entities, the PCAOB and the SEC, a conflict of law exists. Since the SEC is not only in charge of enforcing securities law and also in regulating the PCAOB, the possibility exists to fix these kinds of problems. While current precedent might suggest that Securities Law might trump GAAP in courts, a better solution is to resolve the conflict and bring the two into harmony. The ultimate goal is to have companies provide informative financial statements that are not misleading. The most troubling conclusion from this analysis is that as long as there are contradictions between what is expected of the auditors (by investors and regulators) and what the auditor does (as supported by auditing standards and GAAP), Lehman-type events will continue to be likely.

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