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2011

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## **How Lehman Brothers Used Repo 105 to Manipulate Their Financial Statements**

**Agatha E. Jeffers  
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*The questionable accounting technique, known as Repo 105, allowed Lehman Brothers to temporarily appear healthier in the eyes of its investors, creditors and other interested parties. These material transactions had the ability to affect the decisions of prudent persons. Nevertheless, Lehman failed to disclose these transactions in the notes to their financial statements and in their filings to the SEC. In this paper, an examination is made of whether Repo 105 transactions were properly recorded and disclosed in Lehman's financial statements and whether Lehman's executives behaved ethically. To answer these questions, an examination is made of Generally Accepted Accounting Standards, the Sarbanes-Oxley Act and the Institute of Management Accountants standards. Our findings suggest that Lehman behaved unethically. Implications of our findings are discussed and suggestions are made for future research.*

### **INTRODUCTION**

On September 15, 2008, Lehman Brothers, the fourth largest investment banking firm in the United States filed for Chapter 11 bankruptcy. This filing resulted in a 93% plunge in Lehman's stock from its previous close on September 12, 2008 and led to more than \$46 billion of Lehman's market value. This information is detailed in a 2200 page report filed by a bankruptcy court (United States Bankruptcy Court Southern District of New York In re Lehman Brothers Holdings Inc, et al. Debtors, Chapter 11 Case No. 08-13555 (JMP) – Report of Anton R. Valukas, Bankruptcy Examiner). At that time, Lehman allegedly had \$639 billion in assets and \$619 billion in debt. These amounts made it the largest bankruptcy filing in history and caused Lehman to become the largest victim of the sub-prime mortgage crisis. This bankruptcy rocked the fabric of global society. It intensified the financial crisis and contributed to the erosion of almost \$10 trillion in market capitalization from the global capital markets in October 2008. Soon after its demise, the news of Lehman's use of Repo 105 came to light. As a result, on April 29, 2010, a class action lawsuit was filed on behalf of the purchasers of the securities of Lehman Brothers against three members of the senior executives of Lehman Brothers, including the Chief Executive Officer, Richard Fuld. The suit alleges that the executives failed to disclose their use of controversial accounting technique and misrepresented Lehman's financial position which resulted in a falsely inflated market price of the firm's securities (New York Times, Reuters, June 4, 2010). Repo 105 allowed Lehman to receive cash in exchange for their assets which was used to pay down their liabilities and temporarily show less leverage and appear healthier in the eyes of investors, creditors and other interested parties. Immediately after the publication of their quarterly financial statements and armed with this favorable financial picture of their balance sheet, Lehman went into the open market and secured loans. The proceeds would then be used to repurchase the assets at 105 percent of the cash amount received.

During the Bankruptcy Trial of Lehman Brothers in April 2010, Mr. Richard S. Fuld, Jr., the former CEO was questioned about the accounting technique that helped Lehman mask billions of dollars of troubled assets and liabilities on its books. He however, denies any deliberate wrongdoing. The failure of Lehman Brothers and the crisis that occurred in the subprime mortgage market has led to public outcry against mortgage lending practices. It has also raised the question of the adequacy of the use of accounting practices by investment banking institutions to account for their mortgage transactions which made their financial statements appear better than they actually were.

## **OBJECTIVES OF PAPER**

The Repo 105 transactions were increasingly employed by Lehman in 2007 and 2008 and always increased just prior to the quarterly reporting periods so as to show favorable quarterly reports. Additionally, these were material transactions and had the ability to affect the decision of a prudent person. Nevertheless, Lehman failed to disclose these transactions in the notes to their financial statements and in their required filings to the Securities & Exchange Commission (SEC). These transactions were recorded on the books of Lehman Brothers as sales. The question is as follows: Should Lehman's transactions have been recorded as sales or were these transactions simply secured financing arrangements and should have been recorded as loans and shown on Lehman's balance sheet as liabilities? To answer this question, an examination of Generally Accepted Accounting Principles (GAAP) and requirements with respect to these types of transactions is undertaken. In addition, an examination of Lehman's responsibilities to its investors, creditors and the general public is undertaken and a determination made of whether these responsibilities were met. Additionally, the CEO, Mr. Fuld signed off on Lehman's financial statements yet he denied that he misled investors on these materially misstated transactions. Hence, the responsibility of financial executives in relation to the Sarbanes Oxley Act of 2002 is examined. Further, Lehman's behavior in relation to the standards prescribed by the Institute of Management Accountants (IMA) is examined and a determination made of whether the executives of Lehman Brothers behaved unethically. Furthermore, we suggest future research and examine future policies that can possibly be utilized to circumvent the use of aggressive accounting techniques that could possibly mislead investors.

## **BACKGROUND OF LEHMAN BROTHERS**

For 158 years, Lehman Brothers was one of the biggest, most admired and most consistently profitable investment banking firms on Wall Street. However, their involvement in the subprime mortgages served as the beginning of their downfall. During the housing boom, Lehman acquired several mortgage lenders including Aurora Loan Services, a company which specialized in making loans to borrowers without full documentation. From 2005 to 2007, business in these mortgages resulted in record revenues and caused the performance and growth rate of Lehman to surpass that of its investment banking industry counterparts. However, in 2007, homeowners were unable to pay their mortgage obligations and the housing market began to crumble (Jeffers & Yang, 2008). This resulted in a rapid increase in delinquencies. Investment banking firms like Lehman were forced to write down billions of dollars of debt. These bad loans put a huge dent on the balance sheet of these firms. At the same time, the rating agencies began to focus on the balance sheet and financial leverage ratios of the investment banking firms (Hughes & Jeffers). However, unfortunately for Lehman, the massive amounts of acquisitions and the aggressive expansion strategy that had been employed by them in 2006 had resulted in extremely high financial leverage ratios. An examination of Lehman's condition by the rating agencies would have revealed unacceptably high leverage levels. This poor condition would have resulted in a downgrade of the company and would have led to a decline in the price of Lehman's stock price. This would also have had a negative impact on Lehman's ability to acquire financing as well as resulted in other deleterious consequences for the company. To address this issue and prevent a rating downgrade by the rating agencies, Lehman needed to sell some of its assets or raise additional capital. However, since there was

no ready market for these mortgage assets compounded with the fact that these assets were valued in the market at far less than they were on its books, selling these assets was not a viable option. Hence, Lehman embarked on an alternative strategy to shore up its balance sheet and hide its poor leverage and risky position from the eyes of rating agencies, investors, creditors, regulators and other financial statement users and monitors. This strategy became known as Repo 105.

## **WHAT IS REPO 105?**

Repurchase agreement (repo) transactions have historically been used by companies to manage their short term needs for cash but in Lehman's case, these transactions took on an unusual spin that were designed to make Lehman's balance sheet appear to look healthier than they actually were. Traditional repurchase transactions normally involve an investment banking firm giving a counterparty highly liquid securities in exchange for cash. These are simply financing arrangements and are accounted for as loans with collateral. As such, if the investment bank is unable to repay the loan, the lender sells the assets and gets its money back. The cash received by the company is normally repaid at a later date plus a small amount of interest (normally 2 percent) to get the securities back. Additionally these transactions would generally be accounted for as financing arrangements.

To maintain its stellar reputation, Lehman engaged in this common arrangement but instead of utilizing the normal practices, Lehman employed creative but deceitful accounting practices known as Repo 105. Essentially, Repo 105 is an aggressive and deceitful accounting off-balance sheet device which was used to temporarily remove securities and troubled liabilities from Lehman's balance sheet while reporting its quarterly financial results to the public. These transactions were recorded as sales rather than as loans.

### **Steps in Lehman's Repo 105 Transactions**

The steps involved the purchase of bonds through a Special Financing Unit and intercompany transactions with a London Affiliate. It worked as follows as adapted from (Wilchins, Dan & DaSilva, Silvio, 2010):

Step 1: Lehman Brothers bought a government bond from another bank using its Lehman Brothers Special Financing unit in the United States.

Step 2: Just before the end of the quarter, the U.S. unit transferred bonds to a London affiliate, known as Lehman Brothers International (Europe).

Step 3: The London affiliate gave assets to its counterparty and received cash and agreed to buy back the assets at the beginning of the next quarter at a higher price. Essentially, the assets given were at least 105 percent of the cash received.

Step 4: The monies received were then used to pay off a large amount of Lehman's liabilities.

Step 5: The reduction of assets and liabilities now showed healthier quarterly financial statements and the corresponding leverage and other risk ratios. These healthy ratios were then issued to the regulators, investors and the general public.

Step 6: At the beginning of the quarter and armed with these healthy financial statements, Lehman then went to banking and other lending institutions and obtained loans.

Step 7: A few days later, Lehman Brothers Holding would repurchase the securities from their London Affiliate at 105 percent of the values of the assets. Lehman's assets and liabilities would grow accordingly and the company's leverage would spike back up and its balance sheet and would return to its true inferior position less the 5 percent interest paid.

These transactions usually occurred for a period of seven to ten days around the end of the quarter and created a materially misleading picture of the firm's financial condition. In this accounting maneuver, Lehman would obtain a short term cash loan from its counterparty in exchange for its assets. Lehman would then record this transaction as a sale, when in fact it was simply a secured financing arrangement. Since this was only borrowing money, Lehman should have kept the assets on its books. However, they

did not follow proper accounting rules and instead they removed the troubled assets from their books and recorded the transaction as a sale. The proceeds obtained from these “alleged” sales were used to pay down liabilities. Hence, on the quarterly financial reporting date, Lehman would show a balance sheet composed of less risky assets, less debt and possibly more cash. To outsiders, it appeared as if Lehman was less leveraged and in really great condition. This resulted in the appearance of healthy financial statements and the related healthy financial leverage and other risk ratios. In fact, the bankruptcy Examiner showed that Lehman temporarily reported a net leverage ratio of 15.4 when it should have been 17.3 if it had not used Repo 105.

### Importance of Financial Leverage

A favorable financial leverage means that the company is earning a return on borrowed funds that exceeds the cost of borrowing the funds. The proportion of debt to shareholders equity in the capital structure of a company is of interest to shareholders since a higher debt level means higher risk to shareholders. However, earning a higher return on borrowed funds that exceed the cost of borrowing the funds provides a company’s shareholders with higher return than by using equity funds alone (Spiceland, 2011). However, companies must adequately manage their combination of debt to equity in order to not take on too much risk. Lehman Brothers did not adequately manage this financial leverage and took on considerable risk. To hide its unhealthy situation, Lehman resorted to the use of Repo 105 transactions. To demonstrate the impact of Repo 105 transactions on selected debt ratios and the related improvement on the financial statements, the following hypothetical example is illustrated below.

### Hypothetical Example of Repo 105

Assume that ABC Company received \$50 billion of cash from its counterparty and transferred \$50 billion of assets. If this transaction is recorded as a sale as done under Repo 105, instead of as a secured loan then the following entry would be made:

a) Dr. Cash (Balance Sheet (B/S))	\$50 billion
Cr. Assets (B/S)	\$50 billion

An additional debit or credit will also be made here to recognize a gain or loss and taken to the income statement.

The cash received is immediately used to pay down \$50 billion of long term liabilities. Thus the following entry is made:

b) Dr. Long-term liabilities (B/S)	\$50 billion
Cr. Cash (B/S)	\$50 billion

Accounting rules permit a short term liability for which the company has the intent and ability to refinance to long term to be classified as long-term on the balance sheet. However, with such poor asset quality and without a market for its assets compounded with poor credit ratings, it is unlikely that Lehman would have been able to refinance their short term debt, thus this transaction should have been appropriately recorded as a short term loan. In addition, the company is required to disclose in the notes to the financial statements the nature and amounts of assets that had been pledged as collateral for the loan. If the transaction was properly accounted for and recorded as a secured short term financing to be repaid immediately after the quarterly financial reporting period, then the following entries would have been made.

c) Dr. Cash (B/S)	\$50 billion
Cr. Short Term Notes Payable (B/S)	\$50 billion
d) Dr. Long-term Note Payable (B/S)	\$50 billion
Cr. Cash (B/S)	\$50 billion

In addition, assume the following balance sheet information for ABC Company, and that the company also had \$10 billion of other income from operations. Column 1 shows the position if the company did not use Repo 105. Column 2 shows the information if Repo 105 was used and the transaction incorrectly accounted for as a sale. Column 3 shows the correct information if the proper accounting had been used.

	<u>Column 1</u> <u>Not Used Repo 105</u>	<u>Column 2</u> <u>Using Repo 105</u>	<u>Column 3</u> <u>Should Be This</u>
Current assets	\$50 billion 50(a)(50)(b)	\$50 billion 50(c)(50)(d)	\$50 billion
Long Term assets	<u>\$450 billion</u> (50)(a)	<u>\$450 billion</u>	<u>\$450 billion</u>
Total Assets	\$500 billion	\$500 billion	\$500 billion
Current liabilities	\$ 20 billion	\$20 billion 50(c)	\$70 billion
Long Term Liabilities	<u>\$180 billion</u> (50)(b)	<u>\$130 billion</u> (50)(d)	<u>\$130 billion</u>
Total liabilities	\$200 billion	\$150 billion	\$200 billion
Common Stock	\$300 billion	\$300 billion	\$300 billion
Retained Earnings	<u>\$100 billion</u> 10(e)	<u>\$110 billion</u> 7.5(f)	<u>\$107.5 billion</u>
Total S/Equity	\$400 billion	\$410 billion 7.5(f)	\$407.5 billion
Net income	\$ 10 billion 0	\$10 billion (2.5)(f)	\$7.5 billion

- (a) Repo 105 - The cash is received from the counterparty in exchange for the alleged sale of their long term assets (which are removed from the company's books).
- (b) Repo 105 - The cash received from the alleged sale is used to pay down liabilities (which are removed from the company's books).
- (c) If correct accounting was used then transaction should be a secured loan. The cash is received in exchange for a short term liability (note payable).
- (d) The cash received is used to pay down liabilities.
- (e) Increase due to net income from normal operations.
- (f) Additional 5 percent interest expense that should have been accrued if the Repo 105 transaction had been properly recorded as a loan (\$50 billion x 5% = \$2.5 billion interest expense). This would reduce the net income and retained earnings from \$10 billion - \$2.5 billion = \$7.5 billion.

### Analysis of Ratios

Using the above information from columns 2 and 3, an examination is made of the impact of the use of Repo 105 on 5 selected risk ratios. These are a liquidity ratio, 2 leverage ratios, a profitability ratio and an activity ratio.

#### 1. *Liquidity Ratio*

The current ratio shows whether the company has enough liquidity to pay its current liability. It measures a company's short term debt paying ability. It compares a company's obligations that will shortly become due with the company's cash and other assets that are expected to shortly be converted to cash and offer some indication as to the ability of the company to pay its short term debts. It is calculated as: Current assets/Current liabilities. If the transaction is recorded as a sale, then the current ratio would be = \$50/\$20 = 2.5 to 1. However, if it was correctly recorded, then it would only be \$50/\$70 = .71.

#### 2. *Financial Leverage ratio*

Financial leverage measures the extent to which a firm has been financed by debt in relation to equity. Stockholders desire a certain amount of leverage since it can lead to potentially higher returns. However, if leverage is too high, then creditors become concerned about the potential for default of the company's debt. Thus companies must strategically optimize their use of leverage, activity and profitability to achieve the optimal return on equity while at the same time minimizing their risk. In Lehman's case, the optimum combination of leverage was not

appropriately managed nor achieved. Hence, at the end of each quarter, Lehman embarked on the Repo 105 transactions to deceive the rating agencies, their creditors, investors and others. The net effect of the transaction just prior to the end of each quarter would be that both sides of the balance sheet would be shrunk. This would result in a significant temporary reduction in the leverage reported.

**a. Debt to Equity ratio:**

The most common leverage ratio is the Debt to Equity ratio. It is a financial leverage ratio that measures the extent to which a firm has been financed by debt. It compares resources provided by creditors with resources provided by owners. It is calculated as Total liabilities/Shareholders' Equity. Using the Repo 105 technique, then this ratio would be  $\$150/\$410 = 36.59\%$ . However if it was recorded correctly as a secured loan, then the correct ratio would be  $\$200/\$407.5 = 49.08\%$ .

**b. Liabilities to Total Assets Ratio:**

Another ratio that can be utilized to calculate leverage is to compare the total liabilities to total assets. This is calculated as total liabilities/total assets. Under Repo 105, the ratio would be  $\$150/\$500 = 30\%$ . However, if the proper accounting procedure was used, then it would be  $\$200/\$500 = 40\%$ .

**3. Profitability ratio**

Another ratio that is of interest to stockholders is the **return on equity ratio (ROE)**. This shows the relationship between risk and profitability. As such, it measures the company's financial profitability to stockholders. Using Repo 105, the return on equity ratio would be income of \$10 on Equity of \$410 ( $\$10/\$410 = 2.44\%$ ). However, the actual return on equity ratio should have been income of \$7.5 on equity of \$407.5 ( $\$7.5/\$407.5 = 1.84\%$ ). Using Repo 105, this ROE ratio erroneously implied that the company was experiencing an aggressive growth rate.

**4. Activity Ratio**

A ratio that shows how well a company is managing and utilizing its assets is the **Return on Assets**. It is calculated as Net Income/Total Assets. Using Repo 105, the ratio would be  $\$10/\$500 = 2.0\%$ . However, if the correct accounting methodology had been used, then it would only be  $\$7.5/\$500 = 1.5\%$ .

**Summary of Ratios**

	Using Repo 105	Using Correct Accounting
Current Ratio	2.5	.71
Debt to Equity Ratio	36.59%	49.08%
Liabilities to total assets	30.0%	40.0%
Return on Equity	2.44%	1.84%
Return on Assets	2.0%	1.5%

The above summary of the results show that by using Repo 105, all of these ratios are significantly overstated than if the proper accounting procedures had been followed. The 2.5 times current ratio shows that the company has 2.5 times as many current assets to current liabilities and can meet its current liabilities when they become due plus have additional working capital. However, in reality the company has less than \$1 (only \$.71) of current assets for every dollar of current liabilities. The Debt to Equity ratio shows that the company is not highly leveraged and has a low level of debt (36.59%) in relationship to equity when in fact it is currently at 49.08% and the Liabilities to total assets show 30% when in reality it is 40%. Additionally, both the ROE and the ROA ratios overstate the company's profitability and asset utilization.

An examination of the ratios when the hypothetical company uses the Repo 105 technique shows that the company is well capitalized and less risky. These ratios are totally misleading and mask the high

leverage, riskiness, the low profitability and poor asset utilization of the firm. If creditors knew of this situation then they may get worried and demand that the company pay some of its debt back by selling its assets. This is a situation that Lehman Brothers did not want. When using Lehman's Repo 105 techniques, we see that all of their ratios are overstated. Hence we can conclude that these overstated ratios result in an inaccurate interpretation of the financial position of the hypothetical company and would result in misleading financial statements.

### **Use of Misleading Financial Statements by Lehman**

Armed with its healthy but false financial statements, Lehman obtained loans from financial institutions. However, the obligation to buy back the collateral (troubled mortgage loans) remained with Lehman. Thus, immediately after the financial statements were issued, the company would use the cash obtained from the loans and buy back its original troubled assets at 105 percent of their value. This means that Lehman paid a 5 percent interest rate rather than the normal 2 percent (hence the classification by Lehman as Repo 105). After the repurchase of the troubled assets, Lehman's leverage would spike back up again and its balance sheet would be brought back to its true inferior position (less the 5 percent paid to repurchase their troubled assets). The impact of the Repo 105 transactions allowed the firm to remove approximately \$50 billion of bad assets at the end of its first and second quarters of 2008. This amount is extremely material and allowed Lehman to present a superior balance sheet to the public and appear to be extremely healthy. Anton R. Valukas, Lehman's bankruptcy examiner stated that Lehman's failure to disclose the use of its accounting device to significantly and temporarily lower its leverage, at the same time that it affirmatively represented those "low leverage" numbers to investors as positive news, created a misleading portrayal of Lehman's true financial health. This was significant especially since this was at a time when the general public and financial markets were already extremely nervous. These deceitful window dressing practices deceived investors, creditors, and other interested parties and led to huge losses to investors and others who put their faith as well as their wealth in Lehman.

### **DID LEHMAN VIOLATE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES?**

Over the years, numerous ways have been developed for companies to use their accounts and notes receivables to obtain immediate cash. This is known as factoring of receivables. The use of factoring allows companies to receive cash immediately without waiting for their customers to pay their obligations. The methods of accounting for these transactions are dependent on which rights and risks are retained by the company who originally held the receivables (transferor). Transferors usually prefer to account for these transactions as sales rather than as secured borrowings because the sale approach makes the transferor seem less leveraged, more liquid, and often more profitable than does the secured borrowing approach as shown in the example above.

A company is permitted under Accounting Rule SFAS 140 - *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* to account for these transactions as sales when the transferor surrenders control over the assets transferred. Sometimes surrender of control is clear and is deemed to be when the receivable is sold without recourse and without any other rights, continuing servicing or other involvement by the transferor. At other times, surrender of control is not clear. This cloudiness in the qualifications as to whether the transaction is allowed to be accounted for as a sale or just as a loan with recourse permitted companies to structure transactions in ways that qualified them for treatment as a sale but at the same time, they retained enough involvement to have control (Spiceland, 2011).

It is obvious that Lehman took advantage of this loophole in SFAS 140 in order to account for their transactions as sales instead of as borrowing. Generally, if the value of the principal plus the fee related to the factored security is between 98 percent and 102 percent of the borrowed amount, then the transaction should be recorded for as a loan. However, if the principal plus the premium is less than 98 percent or greater than 102 percent of the amount borrowed, then the loan qualifies to be treated as a sale. Lehman took advantage of this loophole by recording the Repo 105 transactions as sales when they had



the intent to repurchase the assets immediately after the quarterly financial statements had been issued and should therefore have been recorded as secured loans with recourse.

## **FASB'S RESPONSE TO CLOUDINESS IN ACCOUNTING FOR FACTORING OF RECEIVABLES**

When a company sells or uses its Receivables as collateral to receive cash, it is referred to as factoring. To address this ambiguity in the accounting for factoring of receivables and constrain the inappropriate use of the sale approach when control was not indeed transferred, the Financial Accounting Standards Board (FASB) issued *SFAS 166 – Accounting for Transfers of Financial Assets* to amend SFAS 140 – Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (AICPA Codification of Standards, 2010).

### **Accounting Standards**

SFAS 166 stated that the transferor is determined to have surrendered control over the receivables if and only if specific conditions are met. These are as follows:

- a. The transferred assets have been isolated from the transferor – beyond the reach of the transferor and its creditors.
- b. Each transferee has the right to pledge or exchange the assets it received.
- c. The transferor does not maintain effective control over the transferred assets. Effective control would exist, for example, if the transfer is structured such that the assets are likely to end up being returned to the transferor.

The transferor is now permitted under SFAS 166 to account for the transfer of the assets as a sale if and only if all three of the above conditions are met. However, if any of the three transactions are not met, then the transferor must account for the transfer as a secured borrowing.

Since Lehman had the intent to repurchase the troubled assets immediately after the issuance of their financial statements, then these transactions were simply secured borrowings and should not have been recorded as sales but should have indeed been recorded as secured loans.

### **Required Disclosures Regarding Factoring of Receivables**

Furthermore, these Repo 105 transactions were material and should therefore have been properly disclosed by Lehman in their notes to their financial statements. Additionally, the terms of the transfer with respect to rights or interests and obligations of the sales of the receivables should have been clearly stated and the fact that the related assets in the Repo 105 transactions had been appropriately accounted for and removed from the balance sheet. However, Lehman failed to disclose any information regarding the sales of their receivables and other assets in these transactions.

Lehman's failure to disclose the required information of the Repo 105 transactions in combination with the financial crisis caused the FASB to significantly increase the requirements with respect to the amount of disclosure for the sale or transfer of receivables especially in cases where the transferor may still bear significant "risk" with the arrangement. Some of the additional requirements relate to both quantitative and qualitative aspects. The transferring company is also required to disclose information regarding the quality of the assets that were transferred. Examples of this would be the amount of receivables that are past due and the credit losses occurring during the period. This information is required to be disclosed in a manner that permits the average financial statement user to understand the nature, amount and ongoing risks of the transfer (Spiceland, 2011).

### **DID LEHMAN COMMIT FRAUD BY USING REPO 105?**

Lehman's CEO, Mr. Fuld stated that he takes responsibility for his decisions but that they were made with the information available to him at that time. Hence, Fuld is implying that although the financial

statements were misleading, he did not engage in any wrong-doing with respect to their Repo 105 transactions. Failure to disclose an alleged material fact is a potential actionable fraud and does not excuse a clear violation of the anti-fraud provisions of the SEC Act of 1933 and 1934 due to the omission of material facts or misleading statements (Jeffers & Mogielnicki, 2010).

## **DID LEHMAN BROTHERS BEHAVE UNETHICALLY?**

To make a determination of whether or not Lehman acted unethically, it is necessary to undertake an examination of the Institute of Management (IMA's) Standards as well as the Sarbanes-Oxley Act of 2002.

### **The IMA's Code of Conduct**

The IMA's Code of Conduct is applicable to not only management accountants but to managers and executives of companies. This Code presents ethical standards that provide sound, practical advice and was clearly applicable to the managers involved in the Lehman Brothers Repo 105 transactions. Thus, these managers had a duty to abide by the IMA Standards. These standards are Competence, Confidentiality, Integrity and Credibility. An examination of Lehman's actions is undertaken with respect to the 3<sup>rd</sup> and 4<sup>th</sup> standards (Integrity & Credibility).

#### *Did Lehman Violate the Integrity Standard regarding Conflict of Interest?*

The Integrity Standard states that each member has a responsibility to:

- a. Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
- b. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
- c. Abstain from engaging in or supporting any activity that might discredit the profession (Brewer, Garrison & Noreen, 2010).

Lehman's investors and other relevant parties were not advised of the questionable accounting practices of Repo 105. The hiding of the toxic assets and liabilities combined with the favorable financial statements released to investors each quarter clearly deceived investors and the general public. It showed a favorable and healthy Lehman Brothers when in fact the company was in poor financial condition. This action clearly misrepresented the financial position of Lehman and resulted in an inflation of the market price of the firm's securities. In addition, the favorable financial statements produced by Lehman Brothers resulted in many of its senior executives benefiting greatly by receiving huge compensation, bonuses and stock grants. These actions are clearly violations of the IMAs standard of Integrity.

#### *Did Lehman Violate the Credibility Standard Related to Disclosure?*

The Credibility Standard states that each member has a responsibility to:

- a. Communicate information fairly and objectively.
- b. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
- c. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law (Brewer, Garrison & Noreen, 2010).

Lehman failed to disclose the Repo 105 transactions as noteworthy events or transactions. U.S.

GAAP requires a company to disclose significant events that are potentially important to the company's financial statements. These Repo 105 transactions were clearly material and had the potential to impact the decision of reasonable users, however, no information regarding them were disclosed. Repo 105 was relevant, material and could reasonably be expected to influence the understanding, analyses, recommendations and decisions of intended users, yet it was not disclosed to the clients or to the public.

Investment advisors have a fiduciary duty to act in the best interest of their clients, investors and other users. However, Lehman did not do so. Hence an examination of the facts indicates that the behavior of Lehman's managers indeed violated the IMAs Credibility standard.

#### *Did Lehman Violate the Sarbanes-Oxley Act?*

The Sarbanes-Oxley of 2002 was enacted in response to a host of unethical acts by companies. Among other things, the Act requires CFOs and CEOs to personally certify that the financial statements and company disclosures present fairly the financial position of the company. If the financial statements are found to contain material misstatements, these financial executives are subject to severe financial penalties and imprisonment. If Lehman's CEO and CFO knew of the Repo 105 transactions and knew that they caused the financial statements to be misleading, then under the Sarbanes-Oxley Act, they may face criminal charges. From all accounts, it appears as if Lehman's senior financial executives knew of the Repo 105 transactions. Nevertheless, they certified the accuracy of Lehman's financial statements without the appropriate disclosures despite having full knowledge that the company had engaged in the use of inappropriate transactions and accounting manipulations to hide their assets and liabilities and as a result it made their financial statements appear to be in good health when indeed they were in poor condition. As a result, these executives were fully aware that the financial statements were misleading and did not fairly present the true position of the company. Hence, these Lehman executives may be subject to criminal and financial liability.

### **IMPLICATIONS OF FINDINGS**

Our findings have many implications as follows:

1. Lehman's use of Repo 105 may have significantly contributed in some manner to the subsequent bankruptcy of one of the biggest and most well-respected investment banking companies in the world. This has been followed by numerous lawsuits and has raised the question of the responsibility of financial executives to investors and creditors. This suggests that there is no such thing as too big to fail. Thus all firms (big and small) have a responsibility to conduct themselves with the highest degree of integrity.
2. Our findings have also raised the question of the appropriateness of accounting principles. This also led to FASBs revision of the accounting requirements for factoring of receivables as sales or loans. What needs to be determined is how widespread similar conventions were in effect for hiding toxic assets and liabilities by other investment firms.
3. The failure of Lehman to disclose the details related to the Repo 105 transaction to their investors and creditors was an omission of a material fact. This also leads to additional questions: a) Had investors known of Lehman's Repo 105 transactions, would they have declined to continue to conduct business with Lehman? b) Did the investors in fact rely upon omissions and affirmative untrue statements to their obvious detriment? c) If creditors knew of the poor financial health of Lehman, would they have still extended loans to the firm? d) Did the statements and course of conduct of Lehman's executives represent half-truths or were they patently false?
4. It is clear that the conduct of Lehman may not just be unethical but may indeed have risen to the level of actionable fraud under the law.
5. This study has also raised the question of the role of auditors to find and disclose material transactions that may lead to misstatements and their responsibility to protect the public.
6. Lack of appropriate regulation and oversight may have contributed to the ensuing dilemma of the sub-prime meltdown, resulting in the bankruptcy of Lehman, the financial collapse and loss of jobs and income for many Americans. Government did step in by providing a financial bail-out for many other firms in order to prevent a collapse of the industry after defaults in the housing market ran rampant and foreclosures and bankruptcies rose dangerously high. There is no question, though, that future generations will pay dearly for the negative effects of irresponsible

and unethical behavior as in the case of Lehman's use of Repo 105 and the use of questionable accounting practices that lead to the issuance of misleading financial statements.

## **FUTURE RESEARCH**

One area of concern relates to the reliance on the use of several accounting techniques that were used by Lehman's British affiliate that were not acceptable in the U.S. Various e-mails suggest that Lehman's executives knew that they were the only ones using these techniques but were content to use innovative techniques to cook their books. This raises the question of the appropriateness of the use of non-traditional accounting techniques and the disclosures that are required in order not to mislead investors, creditors and other financial statement users.

Another area that needs further investigation is the role that the auditors played in these Repo 105 transactions. Even though Lehman's auditors, Ernst & Young did not audit a Repo 105 transaction, it is obvious that these transactions were not normal accounting practices. To this end, Lehman's auditors had a duty to conduct more tests to assess the impact of their use on Lehman's financial statements. They also had a duty to insist that management disclose these transactions in their notes to the financial statements.

Executives are responsible for the fairness of their companies' financial statements. Yet, there are many cases of violations of the Sarbanes Oxley Act. Will corporate executives be held accountable and sent to jail for their role in the global financial meltdown and will they be required to pay back their unearned bonuses and other compensation when it is found that losses and not profits were sustained by their companies and their financial statements were materially misstated?

## **CONCLUSION**

The use of Repo 105 by Lehman Brothers to hide their assets and liabilities from the public and show a favorable financial position has raised the question of the legal and ethical duties of fiduciaries to their clients and the public. Repo 105 constituted a conflict of interest and serious breaches of ethical conduct. In the interest of fairness, investors have a right to know the true condition of the company in which they are investing. In this paper, an examination is made of the use of Repo 105. Our findings suggest that Lehman acted unethically by violating the Integrity and Credibility standards of the IMAs Code of Conduct in its use of Repo 105 transactions. They also violated the requirements of the Sarbanes-Oxley Act of 2002 by stating that the financial statements were fairly stated when indeed they were misleading. We also find that Lehman engaged in conflict of interest activities and failed to adequately protect their investors. The ultimate decision regarding Lehman's liability and possible criminal culpability with respect to the alleged abuses in their use of Repo 105 and their eventual bankruptcy will be decided by the U.S. Courts. If these abuses are found to be real and egregious, one must wonder when businesses and their executives will realize that their activities can significantly impact the very fabric of human society.

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