Repo 105: An Anatomy of Lehman's Accounting Fraud

The bankruptcy examiner's report in the bankruptcy of Lehman Brothers is a portrait of accounting manipulation and fabrication that stands next to Enron as the epitome of structured financial statement fraud.

Anton Valukas, of Jenner & Block, discovered Repo 105 while investigating Lehman's collapse and detailed its use in his report. Repo 105 was the artful term used to denote the accounting device through which Lehman manipulated and managed its financial statements, which involved temporarily removing billions of dollars of assets from Lehman's balance sheet at the end of each quarter. This gimmick reduced Lehman's leverage ratios, which were crucial to maintaining its required favorable ratings from the principal ratings agencies, and ultimately, to maintaining investor and counterparty confidence.

Lehman ultimately failed for a variety of reasons, including its increasing inability throughout the crisis to securitize and distribute its subprime mortgage originations and its countercyclical growth strategies of using its own balance sheet to acquire assets for long-term investment. These proprietary investments were principally concentrated in three areas: commercial real estate, leveraged loans and private equity. Most of these asset areas would soon implode as the financial crisis expanded.

These countercyclical investment strategies "consumed more capital, entailed more risk, and were less liquid than Lehman's traditional lines of business." Ultimately, as the result of these investment strategies, Lehman desperately needed to raise cash, was unable to sell most of these highly illiquid investments at desirable prices and was forced to turn to massive accounting manipulation to temporarily reduce its balance sheet "solely for the purpose of the firm's public financial reports."

When the financial crisis began, "market observers began demanding that investment banks reduce their leverage." Very generally, Lehman's leverage ratio was calculated by simply dividing total assets by stockholders' equity. In late 2007 and 2008, Lehman substantially increased its use of "Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet." Repo 105 transactions were not used "for a business purpose, but instead for an accounting purpose."

Essentially, "sale and repurchase agreements, or 'repos', are agreements in which one party transfers assets to another party as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time." Lehman, like other investment banks, typically engaged in tens of billions of dollars in repo transactions on a daily basis in its normal course of business. These normalized repos increased the cash account by the amount of cash received, the transferred securities remained on Lehman's balance sheet during the term of

the repo, and liabilities were increased because Lehman "recorded a corresponding liability representing its obligation to repay the borrowed cash."

Any cash used to pay-off current liabilities would have no change in Lehman's leverage position, and would be balance sheet "neutral". These repo transactions were properly characterized and disclosed as financing transactions by Lehman, pursuant to Statement of Financial Accounting Standards No. 140.

Lehman, however, mischaracterized the Repo 105 transactions as sales rather than financing transactions in order to achieve the favorable accounting rules that accompany repo sales. The financial distortions caused by the Repo 105 program were significant and material:

1. The transferred securities were considered sold and removed from Lehman's balance sheet during the term of the repo;

2. No liability was recorded by Lehman representing its obligation to repay the borrowed funds;

3. Lehman then used the borrowed funds to pay down short-term liabilities, reducing its leverage ratios for the period of the repo.

The examiner notes that "the financing Lehman received under a Repo 105 transaction was not the real or primary purpose in entering into Repo 105 transactions. Lehman could have obtained the same financing at a lower cost by engaging in ordinary repo transactions with substantially the same counterparties using the same assets involved in Repo 105 transactions."

This damning indictment highlights the fact that Repo 105 transactions were structurally and substantively identical to ordinary repo transactions, "indeed, Lehman used the same documentation to execute both Repo 105 and ordinary repo transactions, and these transactions were conducted with the same collateral and substantially the same counterparties."

Yet Repo 105 transactions were reported vastly differently from ordinary repo transactions under SFAS 140, as sales rather than financing transactions. Lehman purposely mischaracterized these repo transactions as sales to manipulate its balance sheet. In doing so, it created an accounting fiction to disguise borrowings as sales, reduce net leverage, and increase investor confidence at a time of severe distress to the firm. Lehman's accounting gimmickry is merely the latest example of financial accounting manipulation by the nations (and the world's) largest and most powerful firms.

Had Lehman not collapsed under the weight of a severe operating cash deficit, this accounting fiction would likely have continued. The United States has been wracked by accounting fraud for the last decade, yet it continues unabated. When will the financial community and the regulatory agencies recognize the scope and dimension of the problem? This is perhaps the worst-kept secret in the marketplace: that financial accounting manipulation is rampant and shows no signs of decreasing. How do lowly investors, or even sophisticated market analysts, have any hope of recognizing the badges of financial fraud? The answer, unfortunately, is that they don't.

Next: Ernst and Young, Linklaters, and other enablers.