Closing the GAAP:
FASB Addresses Apparent Loophole that Enabled the Lehman *Repo 105* Fraud

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As thoroughly detailed in the 2,200-page Examiner's Report on the fraudulent accounting that was central to the Lehman Bros. failure – which played a major role in precipitating the global financial crisis that began in 2008, the effects of which are still being felt in 2011 – repurchase agreements ("repos") that should have been treated for financial reporting purposes as secured borrowing arrangements were improperly accounted for as sales transactions. When the proceeds of these loans were used to "window dress" the quarter-end balance sheets by paying down other debts (which itself is not necessarily improper), Lehman was able to materially distort its actual debt-equity ratio by effectively eliminating as much as $50 billion in its outstanding debt obligations from its quarterly balance sheets. Reportedly, it rationalized doing so by citing the fact that the repos had been over-collateralized (by 5% to 8%, thus giving rise to the appellations "Repo 105s" and "Repo 108s"), thus theoretically making the counter-parties (the lenders to Lehman) indifferent regarding hypothetical failures by Lehman to honor the repayment of its debts and its corresponding reclaiming of the collateral put up as security.

The enabling language under the prior rules pertained to the transferor/borrower receiving sufficient proceeds to enable it to replace the financial assets that had been pledged – and arguably the amount borrowed by, e.g., Lehman, was only about 92% to 95% of what would be needed for such action. According to Lehman (as concurred by its auditors, Ernst & Young), this made the opening legs of the sale/repurchase transactions tantamount to sales, rather than secured borrowings, meaning both the underlying assets and the repayment obligations were omitted from its financial statements.

Virtually all experts agree that this treatment was in violation of the spirit of GAAP (primarily found in the FASB's Accounting Standards Codification at Topic 860, which is based on the original SFAS 140), and most believe it even violated the explicit mandates of that standard. Lehman's gambit, although remarkable in its scope, was hardly a new invention, and should have been precluded under extant rules.

Using repurchase agreements to effect "window dressing" of a reporting entity's balance sheet had long been the object of standard-setters' attention, which is why SFAS 140 and its predecessor standards imposed "transfer of control" and related criteria, designed to preclude sale treatment unless the transferor/borrower in fact forfeited control and had no obligation to repurchase the collateral. As sometimes occurs with complex financial reporting rules – heavily abetted by the never-ending creativity of architects of "structured financial products" seeking to assist clients in evading the best-laid intentions of those standards – SFAS 140 may have left some small opening for interpretation, which Lehman appears to have (improperly) wiggled through, with the aid of its British attorneys (apparently no U.S.-based law firm would write the

obligatory "true sale" opinions needed to support "Repo 105" accounting) and its auditors.

As written, SFAS 140 had stipulated that one of the considerations for assessing whether the transferor retained effective control over the collateral was its ability to repurchase or redeem the collateral before maturity. In practical terms, if there was an exchange of collateral in sufficient amount that there would be reasonable assurance that the arrangement's completion on substantially the agreed-upon terms would take place (i.e., that the borrowed amounts would be duly repaid and the collateral would be redeemed), even in the event of the transferee's (lender's) default, the transaction was to be accounted for as a secured borrowing, not as a sale. Note that by over-collateralizing the "Repo 105s" and "Repo 108s," this criterion would seemingly have been generously met, making secured borrowing accounting necessary. Lehman's logic – that, because the lender would gladly forego the closing leg of the sale/repurchase arrangement as it would actually economically benefit from such a default – should have been seen as having no effect on its need to comply with GAAP. Somehow, this was not done, however.

Now, FASB has issued an amendment to the codified version of SFAS 140 that eliminates entirely the "transferor's ability" criterion from the consideration of effective control for repos and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. In Accounting Standards Update 2011-03, it has concluded that the assessment of effective control should focus on a transferor's contractual rights and obligations with respect to transferred financial assets, and not on whether the transferor has the practical ability to perform in accordance with those rights or obligations. Again using the Lehman "Repo 105s" for reference purposes, Lehman's borrowings of as much as $50 billion at any given financial reporting date contractually bound it to repay these loans, making them liabilities, and required that the collateral transferred be kept on Lehman's balance sheets as its owned assets. Had this been done, even use of the proceeds to pay down other obligations (which was not, and will not be, prohibited) would not have resulted in the gross understatement of Lehman's debt/equity ratio, as in fact regularly and increasingly occurred in the years leading up to its demise. Financial analysts, investors and other users would have clearly seen what financial maneuvers were being engaged in, which they may have then approved or challenged, being in possession of the information needed to respond wisely.

It is to be hoped that this simplification of the criteria for distinguishing between actual sales of financial assets and collateralized borrowings using those assets will forestall further abuses such as occurred by Lehman. It also again demonstrates that, in a world of complex financial arrangements, there will be continuing need for financial reporting rules of corresponding scope and specificity, notwithstanding the desire for simplification.

Many readers will be aware of the ongoing debate over the choice between "principles-based" and "rules-based" financial reporting standards. This is usually framed as part of the argument favoring replacement of (arguably rules-based) U.S. GAAP with the (ostensibly more principles-based) International Financial Reporting Standards (IFRS). Advocates favoring IFRS claim that rules-based standards have

effectively created the opportunities for financial engineers and aggressive financial statement preparers to find exceptions to be exploited, which in turn, it is said, has caused the myriad financial reporting frauds of the past decade (WorldCom, Enron, Adelphia, et al.). The argument continues that, if only solid, broad principles for financial reporting were instead substituted, preparers – and auditors motivated to apply strict professional judgment to non-standard transactions – would find little or no leeway for so-called "creative accounting" abuses. Although there are many good arguments to adopt IFRS, the "Repo 105" experience should suggest that there will always be a need for explicit rules: after all, the fundamental requirement to report economic substance and not merely legal form has been part of U.S. GAAP's underlying postulates for many decades. ASU 2011-03 is a welcome revision of GAAP, but the Lehman abuse was clearly a violation of GAAP long before this latest attempt at closing a loophole.

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