When Window Dressing Becomes Fraud:

Repo 105 Was Much More Than *Window Dressing 101*

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The recent, granularly-detailed, exquisitely documented story of the Lehman Brothers collapse is getting a huge amount of attention – from the general public, from legislators seeking yet further rationale for imposing new regulations on the financial services industries, from investors and other aggrieved parties, and of course from plaintiffs' attorneys. The massive 2,200 page Examiner's Report will take some time to fully analyze, but the explosive revelations about the use of so-called "Repo 105" (and "Repo 108") repurchase arrangements improperly accounted for as sales transactions, coupled with the (not necessarily improper) use of the proceeds to "window dress" the quarter-end balance sheets by paying down other debts, is receiving wide notice. It raises a range of issues for financial statement preparers, auditors, legal counsel (particularly those assisting in structuring complex financial transactions), and those using financial reports to make investment decisions.

The use of repurchase agreements is widespread and of long and legitimate standing. At its most pedestrian, this is merely an inventory financing procedure, allowing broker-dealers and others to carry larger inventories (thus enhancing the ability to service customer needs, just as any mundane manufacturing or merchandising enterprise does) using borrowed funds. As with other forms of inventory financing (using trust receipts, etc.), lenders want to establish a security interest as collateral for their loans, and the repurchase arrangement serves that purpose by transferring title temporarily to the lender, which executes a simultaneous forward sale of the collateral back to the borrower. Thus, in a formal legal sense, the borrower engages in an immediate sale and a delayed repurchase, so that, for a time interval that can be as brief as one day, the inventory "belongs" to the lender.

Before modern accounting standards were developed, these transactions were literally accounted for as an immediate sale followed, after the prescribed time had elapsed, as a separate purchase. However, it had long been clear that in substance most of these accords are actually secured borrowings, where the lender has no intention of permanently acquiring the borrower's inventory. By treating these as genuine sales and later repurchases, the intervening balance sheets presented a picture of a more liquid enterprise, perhaps allaying concerns other creditors or investors would have about excessive stocks of risky inventories. In some, not all, instances, the notes to the financial statements should have revealed the true nature of the repurchase obligations, since disclosure of such commitments has long been required under GAAP. (In some past instances of fraud, such as Enron, entities reporting the first leg of repurchase agreements as actual sales would recognize a bogus gain on the sale, thus distorting profits and departing even further from truthful accounting; this does not appear to have occurred in the Lehman case, however.)

There has always been some element of "window dressing" (the term derives from the art of decorating department store windows) in the use of repurchase agreements. Banks and even non-financial institutions with excess cash positions had long experienced spikes in lending activities at month-ends, as broker-dealers and others took steps to clean up their balance sheets for monthly and quarterly regulatory reporting. Lenders obtained good-yielding, fully secured loans for a short period of time; how the borrowers handled the accounting was not necessarily their concern.

In more modern times (at least since the mid-1990s), accounting standards have mainly insisted that repurchase agreements be accounted for by borrowers as secured debt arrangements, so that the inventory (mortgage derivatives and other investments, in the case of Lehman) remained on their balance sheets, along with the borrowed cash (thus increasing total assets) and the corresponding debt payment obligation (thus increasing liabilities and exacerbating the entity's debt/equity leverage ratio). Unfortunately, the current, fairly complex accounting rules (set forth most recently by FASB Statement 140, now codified as ASC 860) leave some small opening for interpretation, which Lehman appears to have (improperly) wiggled through, with the aid of its attorneys and auditors.

According to GAAP, transfers of financial assets (as in repurchase arrangements) may be accounted for as sales only if a series of rather restrictive conditions are met, the substance of which is that control over the assets has to be fully passed to the lender/buyer. Repurchase agreements do not convey this transfer of control, since the borrower/seller (e.g., Lehman) had both the right and the obligation to repurchase the transferred assets upon termination of the agreement, typically in a matter of days or weeks. Incredibly, however, Lehman was able to obtain so-called "true sale" legal opinions (from British firm Linklaters, reportedly after no reputable US-based law firms would render such opinions), which Lehman management then used to convince outside auditors Ernst & Young that for financial reporting purposes, *under U.S. GAAP*, these garden-variety repurchase transactions could be accounted for as sales.

It apparently was rationalized that, because the secured borrowings were significantly over-collateralized (at least nominally – inasmuch as it is suspected that the values assigned to the securities may have been substantially overstated – raising yet another series of accounting and auditing questions), the ostensibly iron-clad obligations to repurchase were not substantive. Arguably, since the lenders held collateral worth 105% of the amount advanced (for debt securities; hence the "Repo 105" appellation), the lenders might not necessarily enforce Lehman's obligation to repurchase the inventory, since they could liquidate the collateral profitably. (Repurchases collateralized by equity securities were nominally 8% over-collateralized, and called "Repo 108s" inside Lehman.) Even if it was true that the liquidation value of the collateral was in such excess of the debt owed plus interest, this wouldn't change the fundamental nature of the secured borrowing obligation, which was thus concealed from financial statement users. Simply put, GAAP requires all liabilities to be presented in the obligor's balance sheet, even if it harbors plans to default on its obligations.

By recording these transactions (as much as $50 billion) as sales rather than secured borrowings, Lehman accomplished the first half of its window dressing scheme. The portion of its inventory used as collateral was removed from the books and replaced by

cash, but no debt was recorded. (The excess of inventory carrying value over cash received – the nominal 5% spread – was reported as a forward purchase derivative asset, yet another "red flag" the auditors ignored.) This first step, alone, left Lehman with the same debt/equity leverage ratio as before the transaction, but misled readers regarding the nature and amount of the repurchase obligation, and portrayed its assets as being more liquid than they were.

The second, and not illicit, leg of the window dressing maneuver was to use the borrowed funds to pay down other obligations, thus slimming down the balance sheet (both cash assets and debt obligations were reduced by equal amounts) but improving the apparent debt/equity leveraging – by only a relatively modest amount, according to the Examiner's Report. Window dressing of this variety is a common period-end tactic used by all sorts of businesses. If "real," it cannot be proscribed (after all, auditors can't vouch for management's intentions in engaging in actual financial transactions). It is only objectionable when it is part of a complex scheme to mislead the users of the financial statements. Put another way, if Lehman had properly accounted for the repurchase transactions as secured borrowings, there would have been no harm whatsoever in using the borrowed cash to window dress via repayments of other obligations.

Taken as a whole, the two-step process engaged in by Lehman would seemingly be a deliberate attempt to conceal, *inter alia*, its holdings of risky, perhaps value-impaired inventory, its large debt obligations for repurchasing that inventory, and its high debt/equity leverage ratio. The fact that the nominal 5% or 8% spreads were shown as forward purchase derivative assets should have been a clear indicator that secured borrowings, not sales, had occurred, and the strange fact that British-law legal opinions were obtained to support U.S. GAAP financial reporting, were but two of the red flags that should not have escaped scrutiny.

Given the efforts to identify the Lehman bankruptcy as having been a key cause of the recent financial crisis that affected not merely the United States, but much of the developed world, "Repo 105" is likely to serve as yet another costly lesson for the auditing profession.

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