

2019

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Recommended Citation

Wiggins, Rosalind Z.; Bennett, Rosalind L.; and Metrick, Andrew (2019) "The Lehman Brothers Bankruptcy D: The Role of Ernst & Young," *Journal of Financial Crises*: Vol. 1 : Iss. 1, 100-123.

Available at: <https://elischolar.library.yale.edu/journal-of-financial-crises/vol1/iss1/5>

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The Lehman Brothers Bankruptcy D: The Role of Ernst & Young¹

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Yale Program on Financial Stability Case Study 2014-3d-v1

October 1, 2014, Revised: July 13, 2015

Abstract

For many years prior to its demise, Lehman Brothers employed Ernst & Young (EY) as the firm's independent auditors to review its financial statements and express an opinion as to whether they fairly represented the company's financial position. EY was supposed to try to detect fraud, determine whether a matter should be publicly disclosed, and communicate certain issues to Lehman's Board audit committee. After Lehman filed for bankruptcy, it was discovered that the firm had employed questionable accounting with regard to an unorthodox financing transaction, Repo 105, which it used to make its results appear better than they were. EY was aware of Lehman's use of Repo 105, and its failure to disclose its use. EY also knew that Lehman included in its liquidity pool assets that were impaired. When questioned, EY insisted that it had done nothing wrong. However, Anton R. Valukas, the Lehman bankruptcy examiner, concluded that EY had not fulfilled its duties and that probable claims existed against EY for malpractice. In this case, participants will consider the role and effectiveness of independent auditors in ensuring complete and accurate financial statements and related public disclosure.

¹ This case study is one of eight Yale Program on Financial Stability (YPFS) case modules considering the Lehman Brothers Bankruptcy:

- *The Lehman Brothers Bankruptcy A: Overview.*
- *The Lehman Brothers Bankruptcy B: Risk Limits and Stress Tests*
- *The Lehman Brothers Bankruptcy C: Managing the Balance Sheet Through the Use of Repo 105*
- *The Lehman Brothers Bankruptcy D: The Role of Ernst & Young*
- *The Lehman Brothers Bankruptcy E: The Effects on Lehman's U.S. Broker-Dealer*
- *The Lehman Brothers Bankruptcy F: Introduction to the ISDA Master Agreement*
- *The Lehman Brothers Bankruptcy G: The Special Case of Derivatives*
- *The Lehman Brothers Bankruptcy H: The Global Contagion*

Cases are available from the Journal of Financial Crises.

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1. Introduction

Ernst & Young Global Limited (EY) served as Lehman Brothers' independent auditors from 2001 until Lehman filed for bankruptcy in 2008. During this period, it reviewed and signed-off on Lehman's financial statements, in each case giving the preferred unqualified opinion. Anton Valukas, the Lehman bankruptcy examiner, raised serious questions about some of Lehman's accounting methods and the role that EY played in allowing certain items to go unchallenged and undisclosed in its financial statements, particularly its use of, and accounting for, Repo 105 repurchase agreements, which enabled Lehman to shift up to \$50 billion from its balance sheet at quarter-end and report more favorable results. Valukas concluded that Lehman's statements were misleading and that plausible claims existed against EY for negligence and malpractice.

EY contended that it had done no wrong. It stood by its opinion that Lehman's financial statements had been prepared in accordance with generally accepted accounting principles (GAAP) and that Lehman's bankruptcy "was not caused by any accounting issues." Valukas and others, however, argued that determining whether the financial statements technically complied with GAAP was neither the proper standard nor the full extent of EY's duty.

The Lehman bankruptcy case also engendered debate regarding the historic role of the independent auditor as one of the few checks on management and whether such firms still have duties to the general investing public.

This case will (1) enable participants to become familiar with the role of the independent auditor in the United States (US), (2) provide participants with an understanding of the regulatory scheme applicable to independent auditors of public companies, and (3) examine and evaluate EY's actions as Lehman's auditor in the years leading to its demise.

The balance of this case is organized as follows: Section 2 discusses the historic role of the independent auditor, and Section 3 focuses on the auditor's role as public guardian. Section 4 discusses the self-regulatory scheme that evolved to set standards for the profession. Section 5 discusses the advent of government regulation in 2002. Section 6 provides information about EY, while sections 7 through 9 analyze different aspects of EY's role as Lehman's auditor with respect to Repo 105. Section 10 concludes with a summary of events occurring after the bankruptcy.

Questions

1. Did EY fulfill its obligations to Lehman and the public?
2. Had developments in the profession and the economy nullified the auditor's duty to the public by 2008?
3. Are auditing firms so beholden to their clients that it is unreasonable to also expect them to be watchdogs for the public interest?
4. Is the regulatory scheme inherently flawed in still requiring auditors to perform this oversight role?
5. Should the regulatory scheme be strengthened so as to compel auditors to be more deliberate in their oversight role?

6. Is it realistic to expect the auditor to take positions against its client's interests no matter what the regulatory scheme?

2. The Historic Role of the Independent Auditor

In the U.S., the role of the independent auditor evolved due to the need to have an independent check on financial information offered by companies. Since management prepares the financials that reflect their performance in running the company, they have an incentive to present the results in as positive a light as possible. Yet, investors need to have data that is transparent, accurate and comparable in order for markets to operate in a reasonable and orderly manner. Having an independent firm audit the company's financial statements provides a check on management. The evolution of accounting and auditing standards made this process even more useful, since investors could then compare financial information across companies.

Public accounting grew into a mature profession in the wake of the passage of the first federal income tax in 1913. The subgenre of independent auditing largely came of age with two systemic changes adopted in the wake of the Great Depression. First, in 1933, the New York Stock Exchange began requiring any company applying for a listing to present an audit certificate for its financial statements, certifying that an audit had been performed by an independent certified public accountant (Wootton and Wolk 1992, 10).

The second defining development was the securities regulatory regime established by the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. These new laws gave the newly established Securities and Exchange Commission (SEC) the mission of ensuring that investors receive full and fair disclosure about securities sold on US exchanges. The new laws required that each company seeking to sell securities had to provide potential investors with a prospectus setting forth specified information about the company's business and finances. Directors and officers could be held liable for any material misstatement or omission in the prospectus, leading them to have the financial statements audited and certified.

The new laws also mandated that all reports filed with the SEC had to include audited financial statements certified by an independent public accountant. These new laws served to increase the prestige for the public accounting profession, and enlarged their responsibility to shareholders and to the general public alike. Not only did accountants have a social responsibility to the public, but they now had a potential legal liability to that public as well (Ibid., 11). Decades later US Treasury Secretary Henry Paulson would state in describing the profession's role: "Our accounting system is the lifeblood of our capital markets" (Advisory Committee Report, C: 8).

A January 2008 study by the US Government Accounting Office (GAO) also succinctly captures the profession's critical role:

Having auditors attest to the reliability of financial statements of public companies is intended to increase public and investor confidence in the fairness of the financial information. Moreover, investors and other users of financial statements expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies' audited financial statements, which is key to the efficient functioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as

independent and expert professionals who will conduct thorough audits” (GAO Report, 7).

Expansion of Services

As the complexity and sophistication of businesses and the economy grew to be more global, the accounting firms expanded accordingly. Companies and investors also relied on accounting firms to validate new products and transactions. Beginning in the 1960s and expanding significantly in the 1980s, the provision of non-audit services by accounting firms soon became a large and profitable part of a firm’s relationship with its clients, often bringing in as much in fees as the audit services did. A firm might provide a client with tax, due diligence, or consulting services, all of which the firm would then audit—in essence signing off on the work of its colleagues. This dual role presented potential conflicts of interest and was implicated in the Enron and other corporate scandals of the late twentieth century. (See Wootton and Wolk 1992 for more history about the role of the public accountant.)

Industry Concentration and Systemic Risk

As client businesses grew and spread globally, so did the accounting firms. Public accounting became highly concentrated, largely through several waves of mergers. By early in the twentieth century the profession had become dominated by the “Big Eight” firms, which provided most services to the country’s larger corporations. By 2008, the Big Eight had shrunk to the “Big Four,”—Deloitte Touche Tohmatsu, PwC, Ernst & Young (EY), and KPMG—as identified in Figure 1.

Figure 1: The “Big Four” Accounting Firms

Firm	Revenues	Employees	Revenue per Employee	Fiscal Year	Headquarters
Deloitte	\$32.4bn	200,000	\$162,000	2013	United States
PwC	\$32.1bn	184,000	\$174,456	2013	United Kingdom
Ernst & Young	\$25.8bn	175,000	\$147,428	2013	United Kingdom
KPMG	\$23.4bn	155,000	\$150,968	2013	Netherlands

Source: Wikipedia: *Big Four (audit firms)*, AICPA 2002.

Since 2003, companies wishing to perform audits for publicly traded companies have been required to register with the Public Company Accounting Oversight Board (PCAOB). (See Government Regulation: The Sarbanes Oxley Act of 2002 below). At the end of 2012, there were 2,363 companies registered, an increase from the 1,874 firms registered at the end of 2008. The GAO Report, however, found that the Big Four firms audited 98% of the 1,500 largest public companies—those with annual revenues of more than \$1 billion—and 92% of public companies with revenues between \$500 million and \$1 billion (GAO Report, 4). The study also found that in 2006, these four firms received 94.4% of all audit fees paid by public companies (Ibid., 16).

In its October 2008 Report, the Advisory Committee on the Auditing Profession (Advisory Committee Report) issued by US Treasury Secretary Paulson, characterized this concentration as a systemic risk to the financial system, one that would increase if one of the

firms were to fail or leave the market (as Arthur Andersen did), leading to even greater concentration. Risks resulting from this concentration included the ability to manipulate fees—or otherwise adversely act as an oligopoly—the inability to hire sufficient qualified personnel to timely meet market needs for audits, and the risk that the quality of audits would be negatively impacted (Advisory Committee Report, VIII: 3). These risks are exacerbated by the GAO finding that a majority of medium and small firms reported no interest in pursuing the audit business of the largest corporations (GAO Report, 5).

Neither the GAO Report nor the Advisory Committee Report included recommendations for how to lessen the concentration in the profession. However, the Advisory Committee recommended greater monitoring by the PCAOB of the largest globally significant accounting firms and greater coordination with international standards, and also recommended that the auditor's report disclose all cooperating audit firms that contributed to the report (in recognition of the decentralized structures of many firms). (For further information see GAO Report, 75-81, Appendix II: Other Issues Related to Concentration in the Audit Market; and Advisory Committee Report, pages II:1-II:10, Co-Chair's Statement; VIII:1-VIII:23.)

3. Independence and Public Responsibility: The Certified Public Accountant as Public Guardian

For much of the twentieth century, accounting was viewed as a stodgy, conservative profession; even its self-imposed rules discouraged competition. But accounting was highly regarded, and the new laws enacted after the Depression helped to solidify the auditor's role and bolster the profession's credibility as an objective reviewer of management's financial statements on which the public could rely.

The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct (AICPA Code) makes it clear that public responsibility continues to be a key hallmark of the profession and, in fact, is intricately linked to the concepts of independence and due professional care:

The public interest aspect of certified public accountants' services requires that such services be consistent with acceptable professional behavior for certified public accountants. Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and independence require that members be free from conflicts of interest in discharging professional responsibilities. Due care requires that services be provided with competence and diligence (AICPA Code §50).

Client Loyalty vs. Public Duty

However, developments in the profession would come to challenge this important principle. Often a company retained an audit firm for a long period of time. For example, EY was Lehman's auditor from 2001 to 2008, and also provided numerous other services. Such longevity was thought to increase the efficiency of the auditor's work since it became more familiar with the company and its management. However, the increasing concentration of the accounting profession, the increased breadth of services they offered, and this tendency for firms to engage an accountant for years, leads to concerns that the accountant's independence and objectivity might be compromised.

The risks to an accountant's independence became more apparent at the beginning of the twenty-first century when a number of auditing firms were implicated in a wave of major corporate scandals, for example, Enron (Arthur Andersen, 2001), Tyco (PricewaterhouseCoopers, 2002), WorldCom (Arthur Andersen, 2002), and HealthSouth (Ernst & Young, 2003). Notably, of the firms implicated, Arthur Andersen did not survive.

There has recently been discussion in the profession regarding whether the CPA continues to have "public responsibility," or whether a CPA owes loyalty solely to the client. A recent PCAOB Staff Alert calls for more attention to these matters, urging auditors to apply more skepticism and to remember that their first loyalty is to investors:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public (*U.S. v. Arthur Young & Co.*, 465 US 805, 817-18 (1984) cited in PCAOB Staff Practice Alert 10, 8).

And in considering EY's role in Lehman Brothers' bankruptcy, Anton R. Valukas, the examiner said:

Nevertheless, and wholly apart from the claims involving Lehman's auditors, we must recognize the general principle that auditors serve a critical role in the proper functioning of public companies and financial markets. Boards of directors and audit committees are entitled to rely on external auditors to serve as watchdogs—to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a "clean" report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat (Valukas 2011, 2-3).

One must, however, question how this responsibility to the public is manifested in real life, given the very real dilemma faced by an audit firm and its engagement partner. Often, as was the case with Lehman, a firm will retain the same external audit firm for several years and bill it millions of dollars in fees. (Lehman paid EY \$150 million in fees between 2001 and 2008.) Audit partners from external firms often develop strong relational ties to clients and have significant personal financial interests in maintaining the account. A large industrial company or bank may be the audit partner's only client, the loss of which may be difficult, if not impossible, to replace with one of like size and stature in a short period of time. Thus, partners of external audit firms, and the firms themselves, have a strong financial incentive to keep clients happy. (See PCAOB Board member Jeannette M. Franzel's comments on auditor independence and communications with the audit committee.)

4. The Self-Regulatory Regime

Despite the regulatory changes of the 1930s, the setting of accounting standards was left to the profession. The Financial Accounting Standards Board (FASB), which grew out of a committee of the AICPA and which was established as a separate entity in 1972 (and became operational in 1973), has responsibility for establishing rules for measuring, reporting, and disclosing information on financial statements of nongovernmental entities. These rules are

collected as generally accepted accounting principles (GAAP). A separate entity of the AICPA, the Auditing Standards Board (ASB), creates standards by which an auditor determines whether information reported on a financial statement is reasonable and conforms to GAAP. These are collected as generally accepted auditing standards (GAAS).

Due Professional Care

Two important tenants of the professional standards that were implicated in the Lehman situation were independence, as discussed above, and due professional care, which imposes a responsibility on the auditor to observe the standards of fieldwork and reporting. These include: (1) exercising professional skepticism, (2) making efforts to detect fraud, and (3) determining whether a particular matter should be disclosed in light of the circumstances and facts which the auditor was aware of at the time. In addition, the auditor is required to inquire about accounting methods, unusual situations and trends, and to report certain things learned during the audit directly to the Board audit committee, including significant accounting policies, methods used to account for significant unusual transactions, and misstatements (even if immaterial and left uncorrected). The auditor is also required to comment to the audit committee on the quality of management's accounting policies, not just their acceptability [AU §§ 230, 380 and 561. (PCAOB auditing standards are cited herein as AU, followed by a section number.)]

The Auditor's Report

The intended result of the auditor's review is the audit report providing an unqualified opinion certifying, according to the standard report wording, "that the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles [GAAP]." An opinion other than an unqualified one can have considerable impact, as deal terms often require a party to deliver financials supported by an unqualified opinion. Delivering less can be considered a negative and can derail a transaction. (See Appendix A for AU §508, showing the standard audit report form as well as other options.)

In each year from 2001 through 2008 EY reviewed and signed off on Lehman's financial statements, giving an unqualified opinion that the statements had been prepared in accordance with GAAP. However, professional standards provide that technical compliance with GAAP is not sufficient to support an unqualified opinion. "Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form" (AU § 411.06).

Additionally, several courts have ruled that strict application of FASB standards does not ensure compliance with GAAP. GAAP's "ultimate goals of fairness and accuracy in reporting require more than mere technical compliance" (*In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp.2d 319, 339 (S.D.N.Y. 2004) cited at Examiner's Report, Vol. 3, 965). The auditor must consider all the facts and circumstances and determine not just whether the accounting is correct, but also, that, when taken as a whole, the statements fairly present the results and are not misleading; GAAP is but one tool to be used in making this determination (*Ibid.*). (See Appendix B, EY's reports on the financial statements included with Lehman's 2007 Form 10-K and PCAOB Board Member Daniel L. Goelzer's comments on the proposed changes to the audit report.)

5. Government Regulation: The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 (SOX), one of the most significant pieces of business legislation passed in decades, was enacted following the wave of corporate scandals that occurred at the beginning of the twenty-first century in which several companies' accounting firms were implicated in the fraudulent use of off-balance-sheet accounting and other devices. SOX imposed new oversight duties on public companies with respect to their independent auditors and enacted rules designed to prevent accounting fraud. A number of its major points relevant to the Lehman situation are discussed below.

Public Company Accounting Oversight Board (PCAOB)

Recognizing that the prior scheme of self-regulation had failed, SOX established a new independent quasi-governmental body to regulate accounting firms providing audits of public companies. The mission of the Public Company Accounting Oversight Board (PCAOB) is to "protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" for US companies whose securities are publicly traded. The PCAOB issues standards governing public company audits and has adopted several AICPA auditing standards as its interim standards. The PCAOB also conducts periodic inspections of registered firms and has the authority to sanction individual firms and auditors. And as of 2010, pursuant to the Dodd-Frank Act, the PCAOB also monitors and oversees auditors of registered brokers and dealers.

Auditors Must Register with the PCAOB and Be Independent

Since 2002, companies issuing securities subject to SEC regulation must file with the SEC registration statements and other periodic and annual reports that are required to include financial statements that have been audited by accounting firms registered with the PCAOB. Such financial statements must be audited in accordance with standards promulgated by the PCAOB. The auditors must also meet SEC and PCAOB standards for independence. Independence means, generally, that an auditor does not have any financial or fiduciary ties to the client and must not have performed any of the nine non-audit services proscribed by SOX.⁵

Enhanced Company Requirements

SOX requires public companies to have a Board audit committee comprised of "independent directors" (i.e., those not affiliated with the company as statutorily defined), including at least one director who is a "financial expert" (i.e., someone with financial or accounting experience as statutorily defined).

Seeking to disrupt the close bond between management and the auditor, SOX mandates that the Board audit committee, not management, is responsible for negotiating the statement of work and fees with the auditor. Further, the auditor has a duty to report certain findings directly to the audit committee and may meet with the committee in private without management attending. The company must also have its system of internal controls over financial reporting attested to by the independent auditor. (See pages 10-15 of the GAO

⁵ The nine services are: bookkeeping; financial information systems design and implementation; appraisal or valuation services, fairness opinions or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker-dealer, investment adviser, or investment banking services; and legal and expert services unrelated to the audit.

Report for a discussion of statutory and accounting standard changes enacted following SOX and SEC Press Release 2003-9 regarding Rules Strengthening Auditor Independence.)

6. The History of Ernst & Young

Although one of its constituent entities dates back to 1849, the modern incarnation of Ernst and Young (EY) was incorporated in 1989 through a merger of “Big Eight” accounting firms Ernst & Whinney and Arthur Young & Co., then the third- and sixth-largest firms, respectively. The merger created what was at the time the world’s largest accounting firm, reporting post-merger revenues (1990) of \$5 billion. The firm grew steadily, and by 1998, its revenues had doubled to \$10.9 billion. By June 2013, EY employed 175,000 persons with a headquarters in New York and over 700 offices in 150 countries worldwide. However, due to other changes in the industry, its 2013 revenues of \$25.8 billion made it then only the world’s third-largest accounting firm behind Deloitte and PwC, according to *Forbes* magazine.

As described on its company website, EY is a limited liability partnership and operates a series of managed coordinated entities in each country. It services a client base of large firms from varying industries, and its business consists of professional services in four broad categories. Its service lines and share of revenues in 2013 were:

- Assurance Services (43%): comprises Financial Audit (core assurance), Financial Accounting Advisory Services, Fraud Investigation & Dispute Services, and Climate Change & Sustainability Services.
- Tax Services (27%): includes Transfer Pricing, International Tax Services, Business Tax Compliance, Human Capital, Customs, Indirect Tax, Tax Accounting & Risk Advisory Services, Transaction, and Tax.
- Advisory Services (22%): consisting of four subservice lines: Actuarial, IT Risk and Assurance, Risk, and Performance Improvement.
- Transaction Advisory Services (TAS) (8%): deals with companies' capital agenda—preserving, optimizing, investing, and raising capital (EY Global Review).

(For more information see the EY website at <http://www.ey.com> for company data. For a detailed history of EY see International Directories of Company Histories 2000.)

7. Ernst & Young as Lehman’s Independent Auditor

Lehman employed EY as the firm’s independent auditors from 2001 to 2008. In reviewing Lehman’s financial statements, EY had a duty to comply with all professional standards, including to perform tests, gather corroborating evidence to support the financial statements, obtain reasonable assurance about whether the financial statements were free of material misstatements, and provide an opinion regarding whether the financial statements were fairly presented in conformity with GAAP (AU §311). As discussed below, however, EY’s role, as is common in practice, went beyond merely reviewing Lehman’s financial statements. It was a trusted advisor, relied on and consulted with respect to numerous financial and accounting matters regarding Lehman’s vast and sophisticated business. (See Wiggins, et al 2014A for overview of Lehman Brother’s operations.)

Lehman's Repo 105 Policy

Like most investment banks, Lehman regularly used sale and repurchase agreements (repos) to meet its daily short-term borrowing needs, borrowing funds on a short-term basis against assets that it delivered as collateral. A few days later, it would repay the borrowed funds and repurchase the assets. Lehman accounted for standard repurchase agreements as “financings.” It retained the assets on its balance sheet, accounted for the cash as an increase in borrowings, and booked the obligation to repay the loan (and repurchase the collateral) as an offsetting liability; total assets remained unchanged. As discussed below, the significance of treating repos as “sales” instead of “financings” lies in the differing accounting treatment.

In September 2000, shortly after Statement of Financial Accounting Standards 140 (SFAS 140), permitting certain repos to be treated as “sales” rather than “financings” for accounting purposes, took effect, Lehman developed a policy and program explaining how the firm might benefit from the standard. Repo 105, a repo over-collateralized by 5%, was the result. Under its interpretation of SFAS 140, Lehman accounted for Repo 105s as “sales,” rather than “financings.”

This interpretation permitted Lehman to remove from its balance sheet the securities transferred as collateral, reducing assets. The cash received was not booked as borrowings, and the obligation to repay/repurchase was not booked as an increase in liabilities. Instead, the right to repurchase the collateral was booked as a derivative right to purchase securities in the future. Thus, use of Repo 105 transactions enabled Lehman to temporarily remove assets from, and reduce, its balance sheet. Lehman was also able to reduce its non-related debt through use of the cash received, thereby further reducing its net leverage ratio. (For additional analysis and discussion of Lehman's use of Repo 105, see Wiggins, et al. 2014C.)

Because Lehman could not find a US law firm to issue a “true sale” opinion to support its Repo 105 interpretation, it relied on a letter from a UK law firm, Linklaters, for all of its Repo 105 transactions, which it executed by transferring billions of dollars from its US operations to a UK subsidiary (Examiner's Report, Vol. 3, 765-93).

There is some dispute over just what role EY played in the development of Lehman's Repo 105 policy. EY claims to have had no advisory role in development of the policy. However, several Lehman employees remember discussing the policy with their outside accountants. Nevertheless, at some point, EY became aware of Lehman's Repo 105 policy and had numerous discussions with Lehman personnel regarding the practice (Ibid., Vol. 3, 948-51).

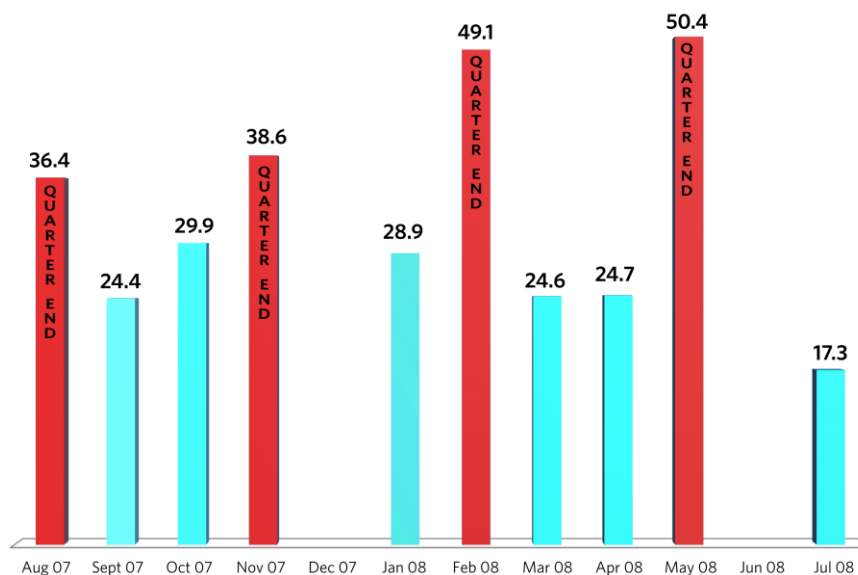
When asked if the Lehman policy was an accurate interpretation of SFAS 140, William Schlich, the EY engagement partner, replied that EY had never evaluated the policy to see if it was a sound interpretation of SFAS 140. Schlich stated that EY did not “approve” of Lehman's Repo 105 accounting policy but that the firm “[became] comfortable with the policy for purposes of auditing the financial statements” and “did not pass upon the actual practice” (Ibid., 948-49). Schlich also insisted that while EY's audit responsibilities required it to inquire whether Repo 105s were accounted for correctly, EY was not required to review the timing or volume of such transactions (Ibid.).

Lehman's Use of Repo 105 in 2007 and 2008

From 2001 through 2006, Lehman regularly engaged in standard repo and Repo 105 transactions in varying volumes. (There was also limited use of a Repo 108 transaction.)⁶ By mid-2007, real estate markets were beginning to show signs of weakening. As Lehman and other investment banks came under greater scrutiny regarding the value of their real-estate-related assets and liquidity, rating agencies and analysts pressured the banks to reduce their leverage.

Due to its inability to sell its substantial position in mortgage-backed securities at or near its book value, Lehman turned to Repo 105, even though by then most of its peers had ceased to use it. As shown in Figure 2, during 2007 and 2008 Lehman significantly escalated its use of Repo 105s to as high as \$50 billion in the second quarter of 2008, which enabled it to temporarily remove corresponding amounts of assets from its balance sheet.

Figure 2: Monthly Repo 105 Usage (in \$billions)



Note: The amounts shown above correspond to the combined totals of Lehman's Repo 105 and Repo 108 transactions for the period.

Source: Derived from Examiner's Report, Vol. 3, 875.

The bankruptcy examiner concluded that Lehman's high volume of Repo 105s enabled it to report a more favorable balance sheet and material reductions in its net leverage ratio, as shown in Figure 3. Had its extensive use of Repo 105s, its related "sale" accounting treatment, and the impact on its leverage ratio been disclosed, Lehman would likely have experienced an immediate and significant negative impact to its credit rating and market confidence. (See Wiggins, et al. 2014C for more about how Repo 105 impacted Lehman.)

⁶ Repo 108 transactions were similar to Repo 105s but utilized equity rather than debt securities as collateral and an 8% haircut. Lehman also treated Repo 108s as sales. Their volume rose as high as 37% of Repo 105 amounts during 2007-Q2, however, Repo 108 usage in Q1- and Q2-2008 represented no more than 13% and 16%, respectively, of Repo 105 amounts.

Figure 3: Lehman's Reported Net Leverage vs. Net Leverage Without Repo 105

Date	Repo 105 Usage	Reported Leverage	Net Leverage without Repo 105	Difference
Q4 2007	\$38.6 B	16.1	17.8	1.7
Q1 2008	\$49.1 B	15.4	17.3	1.9
Q2 2008	\$50.4 B	12.1	13.9	1.8

Source: Examiner's Report, Vol. 3, 748.

In auditing Lehman's financial reports for fiscal year-end 2007, EY reviewed numerous documents and held many meetings with Lehman personnel. EY also analyzed the various balance sheet netting mechanisms used by Lehman, including Repo 105, and reviewed the Repo 105 accounting policy, the related accounting treatment, and the transactions.

EY did not, however, request additional information from Lehman regarding how it reached its conclusions regarding the accounting treatment of Repo 105s under SFAS 140, or ask to see the Linklaters opinion letter, of which it was aware.⁷ It also did not request an explanation from Lehman regarding the amounts or pattern of Repo 105 escalation. And despite its duty to apply "professional skepticism" and to "inquire about unusual situations and transactions," EY never questioned Lehman's Repo 105 usage, notwithstanding the fact that it was an unusually expensive way to raise funds and that it was well-known in the industry that Lehman's peer investment banks had ceased to utilize the mechanism. (See Examiner's Report, Vol. 3, 1028-53 analyzing EY's performance and the EY letter to clients addressing the same.)

8. The Whistleblower Letter and Audit Committee Communication

As Senior Vice President, Global Balance Sheet of Lehman, Matthew Lee's responsibilities included consolidating the financial and accounting information provided by Lehman's subsidiaries from around the world into the one consolidated financial statement used by the firm as the basis for its public reporting. On May 16, 2008, Lee sent a letter to several senior Lehman officers alleging accounting errors and other irregularities (the "Whistleblower Letter")⁸. Lehman's management provided the letter to its Board audit committee, which asked to be informed of all of Lee's allegations, and to EY, which was directed to conduct an investigation into the allegations.

⁷ This may have been because the US Ernst & Young firm considered the Repo 105 transactions, which were executed in the UK using funds transferred from the US, to be subject to the UK audit, not the US audit that it was conducting. Lehman's UK subsidiary was audited by Ernst & Young's UK affiliate. However, it must be remembered, as Schlich acknowledged, that Lehman's financials all rolled up into the US statements. (See Examiner's Report, Vol. 3, 950, FN 3665.)

⁸ "I have become aware of certain conduct and practices, however, that I feel compelled to bring to your attention, as required by the Firm's Code of Ethics, as Amended February 17, 2004 (the "Code"), and which requires me, as a Firm employee, to bring to the attention of management conduct and actions on the part of the Firm that I consider to possibly constitute unethical or unlawful conduct." (Lee, 2008).

William Schlich, the EY engagement partner, interviewed Matthew Lee on June 12, 2008, at which meeting Lee also told EY about Lehman's escalating use of Repo 105 and its impact on the firm's balance sheet. On June 13, 2008, Lehman management and Schlich met with the Lehman Board audit committee to discuss the company's second-quarter financial reports. On July 2, 2008, Schlich again met with the audit committee to review the final statements. On July 10, EY issued an unqualified report regarding the second quarter Form 10-Q, despite the Whistleblower Letter. On July 22, 2008, Schlich attend a full board meeting at which a Lehman officer delivered a presentation regarding the Whistleblower Letter; the presentation did not mention use of Repo 105. Notwithstanding its statutory obligations under SOX and the audit committee's request to be informed of all allegations made by Lee, EY did not inform the audit committee or the full board of Lee's allegations regarding Repo 105 at any of these meetings. Anton Valukas concluded that such failure amounted to negligence and malpractice. (See the Lee Whistleblower Letter.)

9. Lehman's Disclosure

From 2000 through 2008, Lehman prepared its Forms 10-K and 10-Q reports in accordance with GAAP and affirmatively stated therein that it sometimes used repos as a means of short-term borrowings and that it accounted for them as "financings." At no time did Lehman mention in any of its Form 10-Ks or 10-Qs, directly or indirectly, its use of Repo 105s or that it accounted for any of its repo transactions as "sales," pursuant to SFAS 140. Specifically, "[a]n investor reviewing Lehman's 2007 Form 10-K and two 2008 Forms 10-Q would not have been able to discern that Lehman was engaged in Repo 105 transactions" (Examiner's Report, Vol. 3, 973). In fact, there were no disclosures from which an investor could have inferred such. This lack of disclosure contributed to a misunderstanding on the part of investors that Lehman was reducing its balance sheet through sales of assets. (See Wiggins, et al. 2014C for more discussion of Lehman's disclosure.)

Management's Discussion and Analysis of Results of Operations and Financial Condition

Pursuant to SEC regulations, Lehman was required to discuss known trends and uncertainties related to its cash flow, capital resources, and results of operations, as well as unusual and infrequent events and transactions that could have a material favorable or unfavorable impact on the company in its Management's Discussion and Analysis of Results of Operations and Financial Condition (MD&A), included in its periodic reports filed with the SEC (AT §701).

Because Lehman accounted for its Repo 105 transactions as sales rather than borrowings (as it treated other repo transactions), Lehman did not disclose its liabilities arising from the obligation to repay the Repo 105 borrowings. Thus, Lehman was able to borrow tens of billions in cash and use that money to pay off liabilities unrelated to the repos without disclosing that a few days after the close of the quarter it would have to raise tens of billions more to buy back the assets given as collateral (Examiner's Report, Vol. 3, 974). For these reasons, the examiner found that Lehman's MD&A statements about its liquidity and liabilities (i.e., its obligation to repurchase the securities) were deficient and misleading (Ibid., 1027).

Although the MD&A is not covered by the auditor's report, the auditor is required to read the MD&A and to be satisfied that it is clear and complete. It is also obligated to comment on not just the technical correctness of the company's accounting but also on the quality of that accounting. According to interviews with Lehman and EY personnel, EY did not question the sufficiency of Lehman's liquidity and liability disclosures in its MD&A, although it knew that

billions of dollars relating to the Repo 105 obligations were not discussed. It also did not suggest to Lehman that its prior statements might be misleading or might require correction (Examiner's Report, 965).

Several commentators have concluded that even if Lehman's accounting treatment of Repo 105s was consistent with SFAS 140 and GAAP, EY still had a duty to inquire whether the financial statements were materially misleading. The bankruptcy examiner concluded that EY had failed to adequately perform that duty and thus found that possible claims existed against EY for professional negligence with respect to: (1) failing to inform the audit committee of Lehman's usage of Repo 105, (2) its handling of the Whistleblower Letter and Lee's complaint regarding Repo 105, and (3) not challenging Lehman's filing of financial reports that were materially misleading (Ibid., 1027).

10. Postscript

Notwithstanding the bankruptcy examiner's findings, since the release of the examiner's report, in March 2010, the SEC has declined to initiate any proceeding against EY. A May 2012 report indicated that "[t]he staff [of the SEC] has concluded its investigation and determined that charges will likely not be recommended" (Gallu 2012). While it has not publicly closed the case, as of December 2013, the SEC had not commenced any such action. The PCAOB has also not sanctioned EY.

Shortly after publication of the examiner's report, in March 2010, EY sent a letter to its clients in which it disputed the examiner's analysis and conclusions—"Our opinion stated that Lehman's financial statements for 2007 were fairly presented in accordance with US GAAP, and we remain of that view." It further stated with respect to its handling of the Whistleblower Letter that it had not completed its investigation, which had in effect been cut short by Lehman's filing for bankruptcy protection.

As reported in *The Guardian* on June 22, 2012, the UK Accountancy and Actuarial Discipline Board (AADB) decided not to take any disciplinary action against EY or any individuals in connection with its role in auditing the European banking arm of Lehman Brothers, a decision that came after an 18-month investigation.

On January 28, 2013, Lehman Brothers Holdings Inc., the bankrupt holding company, filed an arbitration action against EY, asserting accounting malpractice and breach of contract arising out of EY's annual audits and quarterly reviews of Lehman's financial statements from 2001 to 2008. Lehman sought disgorgement of fees paid to EY and costs it had incurred in entering into Repo 105 transactions. On April 7, 2014, the arbitration panel rendered a final award with prejudice in EY's favor and against Lehman stating that "any wrongdoing associated with Repo 105s is overwhelmingly attributable to Lehman" (EY vs. LBHI, 4). As of October 1, 2014, EY had filed in New York State court to have the arbitration award confirmed for final effect.

In addition, EY has faced various suits from Lehman investors and, in November 2013, announced that it would pay \$99 million to settle one such case, pending court approval. (See *In Re Lehman Brothers Equity/Debt Securities Litigation*.) Still pending in the New York Civil Supreme Court as of October 2014 was a lawsuit brought by the Attorney General of New York seeking to have EY disgorge \$150 million in fees it received from Lehman in the alleged fraud of reviewing Lehman's faulty financial statements. (See *People of the State of New York v. Ernst & Young LLP*.)

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AT Section 701: Management's Discussion and Analysis
 AU 110: Responsibilities and Functions of the Independent Auditor
 AU 230: Due Professional Care in the Performance of Work

AU 311: Planning and Supervision
AU 380: Communication with Audit Committees
AU 411: The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles
AU 508: Reports on Audited Financial Statements
AU 561: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

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Development of this case has been supported by a generous grant from the Alfred P. Sloan Foundation to the Yale Program on Financial Stability.

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Appendix A: AU 508: Reports on Audited Financial Statements Excerpts and Commentary

508.08(j). The form of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[...]

508.08(k). When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20XX, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].

508.10. This section also discusses the circumstances that may require the auditor to depart from the standard report and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

1. *Unqualified opinion.* An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.

2. *Explanatory language added to the auditor's standard report.* Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.
3. *Qualified opinion.* A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.
4. *Adverse opinion.* An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.
5. *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

These opinions are discussed in greater detail throughout the remainder of this section.

Commentary

The current form of auditor report is delivered in a pass/fail rubric without detail or commentary. However, as provided in Section 508.10, EY did have other options available to it other than providing an unqualified opinion. It could have added an explanatory note or issued a qualified, but not adverse, opinion.

A recent proposal by the PCAOB would retain the pass/fail rubric but require additional information and commentary to increase the communicative value of the report and better inform investors.

“Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report ‘critical audit matters’ that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements” (PCAOB Release 2013-005).

For further discussion of developments see also:

- Deloitte Comment Letter regarding PCAOB Release 2013-005.
- Goelzer, Daniel L., PCAOB Board Member, Statement on the proposed new standard for audit reports.

Appendix B: Ernst & Young Reports from Lehman's November 2007 Form 10-K

LEHMAN BROTHERS HOLDINGS INC.

Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of Lehman Brothers Holdings Inc.

We have audited Lehman Brothers Holdings Inc.'s (the "Company") internal control over financial reporting as of November 30, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Assessment of Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of November 30, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of November 30, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended November 30, 2007 of the Company and our report dated January 28, 2008 expressed an unqualified opinion thereon.

Ernst & Young LLP

New York, New York
January 28, 2008

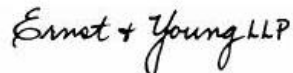
LEHMAN BROTHERS HOLDINGS INC.**Report of Independent Registered Public Accounting Firm****To The Board of Directors and Stockholders of Lehman Brothers Holdings Inc.**

We have audited the accompanying consolidated statement of financial condition of Lehman Brothers Holdings Inc. (the "Company") as of November 30, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended November 30, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lehman Brothers Holdings Inc. at November 30, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended November 30, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Lehman Brothers Holdings Inc.'s internal control over financial reporting as of November 30, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 28, 2008 expressed an unqualified opinion thereon.

The logo for Ernst & Young LLP, featuring the company name in a stylized, cursive script.

New York, New York
January 28, 2008

Appendix C: Mathew Lee “Whistleblower” Letter Text Copy (From *Wall Street Journal*)

MATTHEW LEE

May 18, 2008

PERSONAL AND CONFIDENTIAL

BY HAND

Mr. Martin Kelly, Controller
Mr. Gerard Reilly, Head of Capital Markets Product Control
Ms. Erin Callan, Chief Financial Officer
Mr. Christopher O’Meara, Chief Risk Officer
Lehman Brothers Holdings, Inc. and subsidiaries
745 7th Avenue
New York, N.Y. 10019

Gentlemen and Madam:

I have been employed by Lehman Brothers Holdings, Inc. and subsidiaries (the “Firm”) since May 1994, currently in the position of Senior Vice President in charge of the Firm’s consolidated and unconsolidated balance sheets of over one thousand legal entities worldwide. During my tenure with the Firm I have been a loyal and dedicated employee and always have acted in the Firm’s best interests.

I have become aware of certain conduct and practices, however, that I feel compelled to bring to your attention, as required by the Firm’s Code of Ethics, as Amended February 17, 2004 (the “Code”) and which requires me, as a Firm employee, to bring to the attention of management conduct and actions on the part of the Firm that I consider to possibly constitute unethical or unlawful conduct. I therefore bring the following to your attention, as required by the Code, “to help maintain a culture of honesty and accountability”. (Code, first paragraph).

The second to last section of the Code is captioned “FULL, FAIR, ACCURATE, TIMELY AND UNDERSTANDABLE DISCLOSURE”. That section provides, in relevant part, as follows:

“It is crucial that all books of account, financial statements and records of the Firm reflect the underlying transactions and any disposition of assets in a full, fair, accurate and timely manner. All employees...must endeavor to ensure that information in documents that Lehman Brothers files with or submits to the SEC, or otherwise disclosed to the public, is presented in a full, fair, accurate, timely and understandable manner. Additionally, each individual involved in the preparation of the Firm’s financial statements must prepare those statements in accordance with Generally Accepted Accounting Principles, consistently applied, and any other applicable accounting standards and rules so that the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the Firm.

Furthermore, it is critically important that financial statements and related disclosures be free of material errors. Employees and directors are prohibited from knowingly making or causing others to make a materially misleading, incomplete or false statement to an

accountant or an attorney in connection with an audit or any filing with any governmental or regulatory entity. In that connection, no individual, or any person acting under his or her direction, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any of the Firm's internal auditors or independent auditors if he or she knows (or should know) that his or her actions, if successful, could result in rendering the Firm's financial statements materially misleading"

In the course of performing my duties for the Firm, I have reason to believe that certain conduct on the part of senior management of the Firm may be in violation of the Code. The following is a summary of the conduct I believe may violate the Code and which I feel compelled, by the terms of the Code, to bring to your attention.

1. Senior Firm management manages its balance sheet assets on a daily basis. On the last day of each month, the books and records of the Firm contain approximately five (5) billion dollars of net assets in excess of what is managed on the last day of the month. I believe this pattern indicates that the Firm's senior management is not in sufficient control of its assets to be able to establish that its financial statements are presented to the public and governmental agencies in a "full, fair accurate and timely manner". In my opinion, respectfully submitted, I believe the result is that at the end of each month, there could be approximately five (5) billion dollars of assets subject to a potential write-off. I believe it will take a significant investment of personnel and better control systems to adequately identify and quantify these discrepancies but, at the minimum, I believe the manner in which the Firm is reporting these assets is potentially misleading to the public and various governmental agencies. If so, I believe the Firm may be in violation of the Code.

2. The Firm has an established practice of substantiating each balance sheet account for each of its worldwide legal entities on a quarterly basis. While substantiation is somewhat subjective, it appears to me that the Code as well as Generally Accepted Accounting Principles require the Firm to support the net dollar amount in an account balance in a meaningful way supporting the Firm's stated policy of "full, fair, accurate and timely manner" valuation. The Firm has tens of billions of dollars of unsubstantiated balances, which may or may not be "bad" or non-performing assets or real liabilities. In any event, the Firm's senior management may not be in a position to know whether all of these accounts are, in fact, described in a "full, fair, accurate and timely" manner, as required by the Code. I believe the Firm needs to make an additional investment in personnel and systems to adequately address this fundamental flaw.

3. The Firm has tens of billions of dollar of inventory that it probably cannot buy or sell in any recognized market, at the currently recorded current market values, particularly when dealing in assets of this nature in the volume and size as the positions the Firm holds. I do not believe the manner in which the Firm values that inventory is fully realistic or reasonable, and ignores the concentration in these assets and their volume size given the current state of the market's overall liquidity.

4. I do not believe the Firm has invested sufficiently in the required and reasonably necessary financial systems and personnel to cope with this increased balance sheet, specifically in light of the increased number of accounts, dollar equivalent balances and global entities, which have been created by or absorbed within the Firm as a result of the Firm's rapid growth since the Firm became a publicly traded company in 1994.

5. Based upon my experience and the years I have worked for the Firm, I do not believe there is sufficient knowledgeable management in place in the Mumbai, India Finance functions and department. There is a very real possibility of a potential misstatement of material facts being efficiently distributed by that office.

6. Finally, based upon my personal observations over the past years, certain senior level internal audit personnel do not have the professional expertise to properly exercise the audit functions they are entrusted to manage, all of which have become increasingly complex as the Firm has undergone rapid growth in the international marketplace.

I provide these observations to you with the knowledge that all of us at the Firm are entrusted to observe and respect the Code. I would be happy to discuss any details regarding the foregoing with senior management but I felt compelled, both morally and legally, to bring these issues to your attention. These are, indeed, turbulent times in the economic world and demand, more than ever, our adherence and respect of the Code so that the Firm may continue to enjoy the investing public's trust and confidence in us.

Very truly yours,

MATTHEW LEE

cc: Erwin J. Shustak, Esq.