Lehman brother’s scandal essay

ASSIGN BUSTER

Lehman Brothers had humble origins, tracing its roots back to a small general store that was founded by German immigrant Henry Lehman in Montgomery, Alabama, in 1844. In 1850, Henry Lehman and his brothers, Emanuel and Mayer, founded Lehman Brothers. While the firm prospered over the following decades as the U. S. economy grew into an international powerhouse, Lehman had to contend with plenty of challenges over the years.

Lehman survived them all – the railroad bankruptcies of the 1800s, the Great Depression of the 1930s, two world wars, a capital shortage when it was spun off by American Express in 1994, and the Long Term Capital Management collapse and Russian debt default of 1998. However, despite its ability to survive past disasters, the collapse of the U. S. housing market ultimately brought Lehman Brothers to its knees, as its headlong rush into the subprime mortgage market proved to be a disastrous step. As the credit crisis erupted in August 2007 with the failure of two Bear Stearns hedge funds, Lehman's stock fell sharply.

During that month, the company eliminated 2, 500 mortgage-related jobs and shut down its BNC unit. In addition, it also closed offices of Alt-A lender Aurora in three states. Even as the correction in the U. S. housing market gained momentum, Lehman continued to be a major player in the mortgage market. In 2007, Lehman underwrote more mortgage-backed securities than any other firm, accumulating an $85-billion portfolio, or four times its shareholders' equity. In the fourth quarter of 2007, Lehman's stock rebounded, as global equity markets reached new highs and prices for fixed-income assets staged a temporary rebound.

However, the firm did not take the opportunity to trim its massive mortgage portfolio, which in retrospect, would turn out to be its last chance. Lehman Scandal Lehman scandal involves the use of an accounting technique that known as Repo 105. Repo is the term stands for sale and repurchase. It is also the agreements where one party transfers an asset or security 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 put up collateral equal to 105 percent of the cash it received which brought the name ' Repo 105'.

By using this technique, Lehman could give the impression that it had reduced its lending as well as cut down the risk taking. This help to make its balance sheet look better. Repo 105' examiner Anton R. Valukas, appointed by court, states that Lehman's Repo 105 practice consisted of a two-step process. First, by undertaking the Repo 105 transactions, and then using the Repo 105 cash borrowings to pay down liabilities, thereby reducing leverage. It's different from the ABC situation since it's treated as a " sale" and thereby Lehman was able to remove the illiquid assets off balance sheet.

According to the examiner report, Lehman was able to move $50 billion of illiquid assets off its balance sheet. Looking at Lehman's publicly reported net leverage ratio for Lehman's publicly reported net leverage ratio for November 30, 2007 (fourth quarter 2007), February 29, 2008 (first quarter 2008), and May 31, 2008 (second quarter 2008) was 16. 1x, 15. 4x and 12. 1x, respectively. Without the balance sheet benefit of Repo 105 transactions, Lehman's net leverage ratios for the same periods would have been 17. 8x, 17. 3x and 13. 9x, respectively.

Involvement of Auditor in this Scandal The Examiner finds that sufficient evidence exists to support at least three colourable claims that could be asserted against Ernst & Young relating to Lehman’s Repo 105 activities and reporting. Firstly is negligence in connection with the investigation into whistleblower Matthew Lee’s claims concerning $50 billion in Repo 105 activities at the end of the second quarter 2008, including failing to conduct an adequate inquiry into the allegations before the filing of Lehman’s Form 10 Q, and failing to properly notify management and the Audit Committee of Lee’s allegations.

There is also sufficient evidence to support the existence of a colourable claim against Ernst & Young for malpractice in connection with the misleading statements concerning Lehman’s net leverage ratio contained in the MD&A sections of Lehman’s two 2008 Forms 10 Q. Sufficient evidence exists to find that those disclosures were materially inadequate and misleading because Lehman did not disclose the fact that the reported assets, net assets, leverage ratio and the reduction in the net leverage ratio were materially affected by temporary Repo 105 transactions.

Next, there is sufficient evidence to claim that Ernst & Young failed to exercise due professional care by failing to notify the Audit Committee of Lee’s allegations about end of quarter Repo 105 transactions as a means to manipulate publicly reported balance sheet reductions. In fact, Ernst & Young knew or should have known that the notes to the financial statements were false and misleading because, among other things, those notes describe all repos as “ financings,” which Ernst & Young knew was not the case, and those notes did not disclose the Repo 105 transactions.

And lastly, even worse, Ernst & Young told the examiner that it didn’t even look at whether the volume of Repo 105 transactions was material to Lehman’s balance sheet and net leverage ratio. Ernst & Young personnel claimed that they only agreed to the account treatment applied to the transactions, but didn’t actually look at the transactions themselves, their overall impact on the financial statements, and the real reason why they were used.

Conclusion Auditor shouldn’t simply singing off on a theoretical accounting treatment, and not examining any of the transactions or their materiality to the financial statements doesn’t seem to meet the professional standards to which auditors must adhere. Auditors must have sufficient, competent evidence to support their audit opinions, and that seems to be lacking in the Lehman Brothers case. The investing public really can’t rely on auditors reports to give them much comfort, and the case of Lehman Brothers is an example of why.