Lehman Brothers: The Case Against Self-Regulation

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This paper examines the failure of the investment firm Lehman Brothers five years after the failure of the firm. We examine weaknesses in corporate governance within the firm. Empirical evidence supports and suggests that the failure of Lehman Brothers was predictable. We also examine Dodd-Frank and other subsequent legislation enacted post-financial crisis and find while the legislation limits the exposure in the financial sector, it does very little in reducing the risks of similar events in other industries.

INTRODUCTION

This article addresses weaknesses in the U.S. financial reporting system disclosed in the bankruptcy of the investment firm Lehman Brothers. We examine the impact weaknesses in the corporate governance had on both the financial reporting system and the firm's risk exposure. The specific weaknesses addressed are in corporate governance within the firm. The paper examines and suggests improvements in corporate governance from within the firm, supported by improved regulatory oversight and corporate governance restrictions.

Prior to bankruptcy filing, Lehman Brothers used an accounting treatment for repurchase agreements ("Repo 105") that was acceptable under US generally accepted accounting standards ("GAAP") but in subsequent financial statement disclosures distorted the true financial condition. (For a detailed analysis of Repo 105 transactions, see our paper on Lehman Brothers, "Law and Accounting: Did Lehman Brothers Use of Repo 105 Transactions Violate Accounting and Legal Rules" in the *Journal of Legal, Ethical and Regulatory Issues, Volume 16,* which concludes that conflicts between law and accounting contributed to the accounting practices which ultimately resulted in the downfall of Lehman Brothers. This paper continues the analysis by addressing the specific inner workings at Lehman Brothers.) This discussion suggests the present state of corporate governance, based on self-regulation with limited oversight, will continue to contribute to financial reporting failures.) The intent of management in using Repo 105 transactions was to improve the presentation of financial condition. The transactions appeared to serve no other purpose than to provide for financial window-dressing. Lehman Brothers executives used Repo 105 transactions over a 7 year period, impacting both quarterly and annual filings. Yet, the financial impact of the transactions was not disclosed to or identified by the board of directors. This paper then addresses the weaknesses in corporate governance and current governance provisions that permitted financial statement manipulation without fair disclosure.

This discussion is relevant for several important reasons. First, the policies and procedures in place at Lehman Brothers were also in place at other financial institutions at the time. Furthermore, the discussion suggests that faults disclosed in the basic processes of presentation, disclosure, attestation, and regulations exist for firms in other industries. The lack of transparency contributes to financial market distortions by not informing investors of the true financial condition. In addition to capital market inefficiencies, the evidence from Lehman Brothers suggests that the ability to bolster financials leads firms to engage in more risky ventures. The restrain provided from fair presentation is removed. Thus, failure in oversight at one level mushrooms into failure on a grander scale.

Second, by examining Lehman Brothers, we show an extreme case of both real activities manipulation and earnings management that had a lasting and significant impact on financial markets and the global economy. (Technically, the procedure was used to manage leverage and not earnings, however, at Lehman Brothers the principle stakeholders were debtors and not stockholders. The financing was from outside debt holders versus from investing clients (Dumontaux and Pop, 2012). We submit that in a firm financed significantly through stock, earnings would have been relevant. From our reading of the Valukas Bankruptcy Report, we surmise that leverage was the primary financial target at Lehman Brothers.) We argue that had disclosures been fair and prompt, both regulators and investors could have responded more quickly and a part of the crisis could have been pre-empted. Thus, without making significant changes, failures in other markets, with potential global impact may occur. We argue that the board of directors in this case, failed to provide management oversight.

Third, the events, processes, and actions of the parties are well documented within the Lehman Brothers bankruptcy examiner's report (henceforth "Valukas Bankruptcy Report"). This report is a unique source of more detailed information than is usually provided in cases analysis by the SEC and provides a basis for close examination of the facts. The facts we provide are also available to other researchers. We are able to examine internal corporate workings, the effectiveness of board policies/procedures, trace regulatory response and to note where weaknesses exist in the current reporting environment. We justify our conclusions with extant research which supports the weaknesses and need for changes in the way corporations are governed.

While other researchers have focused on the impact of the financial crisis on accounting standards (Alwan, 2012; Balaciu and Gherai, 2011; Kothari and Lester, 2012) few studies address the financial crisis from the role of corporate governance. Our study is closest to that of Achim et al. 2010 who examine the need for corporate social responsibility given the financial crisis. Yet, our paper is distinctly different as we address the US financial reporting system and give evidence from the failure of one of the three major US institutions that failed during the crisis.

The article is organized as follows. First, a general discussion of the conditions at Lehman Brothers including the reliance on Repo 105 agreements; second, we discuss the weaknesses in the current reporting environment that permitted the Repo 105 financial impact to not be disclosed. Lastly, we provide a discussion of possible changes in the reporting environment to address the weaknesses and the inadequacies of recent regulations (including Dodd-Frank provisions) in addressing these weaknesses.

BACKGROUND

Conditions at Lehman/Reliance on Repo 105 Agreements

Prior to the collapse, Lehman Brothers was the 4th largest global financial services firm and the oldest of the five major global financial services firms (SourceWatch). In addition to Bear Stearns and AIG, Lehman Brothers was a major institution that failed during the financial crisis (Johnson and McAfee, 2010). The failure of Lehman Brothers is believed to have impacted financial markets for weeks, creating a contagion effect in other financial institutions (Dumontaux and Pop, 2012). Equity underwriting companies alone lost $23 billion in aggregate risk-adjusted losses in the 7 days surrounding Lehman's bankruptcy (Fernando et al., 2012). While it was hardly the sole cause of the financial crisis, the failure of Lehman Brothers was a substantial event causing loss of confidence in the financial and banking systems.

On September 15, 2008, Lehman Brothers filed for bankruptcy. The Lehman Brothers bankruptcy is the largest reported U.S. bankruptcy –twice as large as the second, Washington Mutual (CNN Money). Bank debt at Lehman Brothers was $613 billion. Prior to the bankruptcy filing, investors were aware of Lehman's increasing financial difficulties. However, use of financial statement "window-dressing" through off-balance sheet transactions, such as Repo 105, disguised the extent of the financial difficulties. One can argue that had regulators and investors been informed of the true condition at Lehman Brothers (and other firms), some of the problems in the financial crisis may have been averted. Certainly, regulators would have had a clearer picture of the deteriorating financial condition at Lehman Brothers.

The bankruptcy filing by Lehman Brothers provided information on the repurchase transactions. Had Lehman Brothers not filed for bankruptcy, the accounting practices may have not been disclosed. Bank of America and Citigroup have admitted to misclassifying agreements as sales instead of collateralized borrowings.

Beginning in the 1990's, Lehman Brothers increased the usage of global repurchase agreements (Powell, 1992). The use of repurchase agreements was seen as a low cost way to reduce financing costs. By agreeing to repurchase the asset, the asset was collateralized. The lender retains an amount, termed the haircut, as a precaution against risk of default (Powell, 1992). In 2001, Lehman Brothers management recognized that the implementation of a new accounting standard, Statement of Financial Accounting Standards (SFAS) 140 (effective April, 2001) provided a way to use repurchase agreements to manage financial statement presentation, in particular the amount of leverage present in the financial statement (Valukas, Volume 3, page 765). The provisions of SFAS 140 permitted Lehman Brothers to record the collateralization as a sale, removing assets without reporting losses and generating cash without recording the imminent repayment liability. Internally, the new accounting treatment was vetted with business divisions and groups, including legal, compliance, and accounting policy. Externally, the matter was vetted with the outside auditor. After several months of discussion, the accounting procedure, Repo 105, was accepted formally as a policy (Valukas, Volume 3, page 766). The board was not consulted as to this policy.

In 2006, Lehman Brothers' management and board decided to adopt a new business model. While the previous business model consisted of holding securities for a short period of time, the new strategy was to invest in longer term assets (Caplan et al., 2012) and to grow the firm by aggressively increasing holdings (Dutta et al. 2010). However, Lehman Brothers did not match long term investments with long term liabilities, but continued to finance through short term debt. Thus, the illiquid, high risk investments increased from $87 billion in 2006 to $175 billion at the end of first quarter, 2008 (Valukas, Volume 1, page 57). In 2007, approximately 96% of assets were supported by debt, most of that short term (Valukas, Volume 3, page 751). This new business model forced Lehman Brothers to borrow billions of dollars to finance new investments. By using short term financing, maintenance of credit ratings was imperative.

The new business model had higher inherent risk. Not only was Lehman forced to find short term financing when market conditions were worsening, the assets purchased included substantial amounts of residential and commercial mortgage-backed securities that proved to both be illiquid and declining in value (Hines et al., 2011). Thus, the assets did not provide value to borrow against. The assets could not be sold, without incurring losses; and to sell at a loss would signal to investors a worsening of financial condition.

Of particular concern to investors in Lehman Brothers were the leverage and the leverage ratio (Valukas, Volume 3, page 800). Management at Lehman Brothers understood investors' concerns and in 2007 discussed the impact a deteriorating balance sheet and leverage condition would have on the company. The concern was that market declines and ratings downgrades would result if the financial condition were not improved (Valukas, Volume 3, page 800). As conditions at Lehman Brothers deteriorated, the firm increased its use of the Repo 105 agreements. By 2nd quarter, 2008, Repo 105 transactions were at $50.38 billion. While conditions were worsening at Lehman Brothers, use of the Repo 105 transactions enabled Lehman Brothers to show an improvement in net leverage that was not justified by operations. The estimated reduction in leverage from Repo 105 transactions in Q4, 2007 is 10.56% and in Q2, 2008, 14.89% (Dutta et al. 2010). The usage of the Repo 105 transactions, as attested by internal Lehman Brothers discussions, served no economic purpose other than to improve financial statements (Valukas, Volume 3, page 1015). Thus, the use of the Repo 105 agreements and the subsequent accounting treatments were not in the best interest of the corporation.

Within Lehman Brothers, the executives found the reliance on Repo 105 transactions to meet financial goals as troubling. First, Repo 105 transactions were more expensive than other financing methods. While repurchase agreements generally provide lower cost financing (Powell et al. 1992), Repo 105 agreements were more costly than standard repurchase agreements (Valukas, Volume 3, p. 877-882). Counterparties charged higher interest. Haircuts were higher. Global financing was more expensive. Also, by trading with only a few parties, the market was limited. Second, Repo 105 transactions did not promote effective or efficient operations. By relying on Repo 105 transactions, the firm (and traders) could invest in more speculative, higher risk ventures, knowing that financial condition could be improved by using the Repo 105 agreements. Thus, Repo 105 agreements resulted in less disciplined trades (Valukas, Volume 3, pg. 815), arguably contributing to the demise of the firm.

In 2006, Lehman Brothers executives had suggested an appropriate cap on Repo 105 (exclusive of Repo 108 transactions) at $17 billion (Valukas, Volume 3, page 921). This cap of $17 billion was approximately one times leverage. Yet, in the fourth quarter of 2008, the amount on the leverage position was nearly 3 times what Lehman Brothers executives had set as a limit. Lehman Brothers executives were committed to a course of action which included the use of Repo 105 transactions to bolster financials.

Non-management directors were not informed of the usage of Repo 105 transactions in reducing leverage until allegations by whistleblower Matthew Lee were made known (Valukas, Volume 3, page 945). Once informed of the allegations, the audit committee explicitly instructed corporate audit and the external auditors to keep the audit committee informed (Valukas, Volume 3, page 946). By this time, the financial condition of the company had declined beyond repair.

Corporate Governance within Lehman Brothers

Board Oversight

Lehman Brothers was highly levered, with roughly 3-4% of assets from stockholder's equity. (These statistics are compiled from Lehman Brothers 3Q2007 results.)The remaining assets were supported by debt. Thus, the primary stakeholders (principals) in Lehman were investors in debt instruments. The CEO at Lehman Brothers, Richard S. Fuld, Jr., was also chairman of the board and served in the dual capacity from 1994. Fuld, in January of 2008, owned 2.41% of outstanding common stock, more than 50% of the outstanding common stock held by officers and directors. (The principal beneficial stockholders (percentage owned) listed in the proxy for the 2008 annual meeting were AXA and related parties (7.25%), ClearBridge Advisors, LLC and related parties (6.33%), and FMR LLC and related parties (5.87%)).The remaining 11 members of the board were not members of management and were, in 2007, considered independent by the NYSE independence rules. Lehman Brothers also established categorical independence rules and deemed that the directors were independent.

According to the proxy statement for the 2008 annual meeting, the non-management directors, with the exception of one director who received no compensation, were paid an average of over $365,000 ($420,000) in director fees (including distributions of profit and returns of capital and including those on behalf of directors' children). The nine directors that received compensation earned a minimum of $325,000. In addition to the compensation and distributions/returns, eight directors had brokerage or investment accounts with the firm, six directors had investment in investment partnerships, and four served on boards that provided revenue to Lehman Brothers. Lehman Brothers also contributed to charities with affiliation to four of the directors. Thus, while NYSE standards and internal Lehman Brothers standards classified the non-management directors as independent, only one of the ten directors had no financial ties to Lehman Brothers. We note the board did meet 8 times in 2007 and board members attended on average 75% of the meetings. In addition to full board meetings, the non-management directors held 5 separate sessions in Fiscal 2007.

The audit committee was headed by a director who had been a former CEO and chairman of the board of Halliburton, and was deemed “an audit committee expert”; however, the proxy statement does not indicate the chair had experience in financial services, investment services, or banking industry. None of the members, other than the chair were deemed financial experts and no members of the audit committee had experience in financial services, investment services, or banking that would have assisted in understanding the financial decisions at Lehman. According to Lehman’s nominating and corporate governance committee guidelines, the board seeks candidates that will contribute to relevant industry-specific or other specialized knowledge (Def 14a, March 28, 2008, page 11). The other members of the audit committee had business experience from real estate development, theatre production, and a global healthcare company.

The Board of Lehman Brothers also had a Finance and Risk Committee. The Finance and Risk committee was charged with reviewing and advising the board on “the financial policies and practices of the Company, including risk management” and met two times in 2007 (Def 14a, March 28, 2008, page 11). This committee was comprised of 5 members, with the chair president of an investment management and economic and financial consulting firm. The chair had over 26 years of experience in investments, was in charge of research departments, and had served as an economist for the Federal Reserve. The other members of the committee did not have experience in investment management. Although the chair had investment management experience, when later questioned by the bankruptcy examiner, he stated that he did not believe that $50 billion in Repo 105 transactions was a significant amount, although he would consider a four or five point change in leverage significant (Valukas, Volume 3, pages 946-947).

The Finance and Risk Committee received periodic updates on Lehman’s stress testing (Valukas, Volume 1, page 76). Stress testing was an evaluation of the company’s to quantify potential losses, as required by the SEC (Valukas, Volume 1, page 66). The projections were designed to measure tail risk, a one in ten year event (Valukas, Volume 1, page 66). However, the committee was not informed that many of the investments were excluded from the stress testing. Management later informed the Finance and Risk Committee of the omission in a disclosure notation. According to the bankruptcy report, some directors believed that the exclusions were reasonable. The exclusions in the stress test were significant, potentially increasing losses from $2 billion to $9.4 billion or excluding $7.4 billion in potential losses (Valukas, Volume 1, page 69). Another stress test indicated the exclusions were at $10.9 billion. Internal auditors also advised that the main risks in the portfolio should be addressed (Valukas, Volume 1, page 68). The bankruptcy report finds that the majority of the overall tail risk (or the risk that the firm was facing) was in the investments that were excluded from the stress testing (Valukas, Volume 1, page 69). Thus, the board was ill-informed as to the company’s risk exposure.

At Lehman Brothers, there were also limits on single transactions designed to limit risk exposure. The Executive Committee, consisting of the CEO/Chairman and another director retained the ability to waive single transaction limits. In late 2006, senior management found that single transaction limits were causing the firm to miss investment opportunities and began waiving the limits. The board was not informed of the waiving of limits (Valukas, Volume 1, page 78). Firm wide limits were also changed by altering the way in which calculations were made (Valukas, Volume 1, page 72).

The risk management system was presented to the board and to the SEC as an effective means to constrain risk taking, yet, management was able to circumvent the constraints by altering calculations, excluding investments, and over-riding rules (such as those on single limit transactions). The board at Lehman Brothers was made aware of the intent to both increase risk exposure and to expand investments and agreed with the decision to increase risk (Valukas, Volume 1, page 76). They were not informed of the Repo 105 transaction‘s impact on leverage nor the changes in risk management system that made meaningless the risk assessments of management.

Identified Weaknesses in Corporate Governance

At Lehman Brothers, the power within the board was centralized in the CEO/Chairman, Fuld, who held more than 50% of the beneficial ownership owned by directors and officers. The inability of the CEO to recognize balance sheet impairment may have been related to his long tenure as CEO (Plumb and

Wilchins 2008). Fuld had been a member of the board since 1990, thus, only one of the directors (in fiscal 2007) pre-dated him in board tenure. With the exception of one director, all the directors were elected after Fuld became Chairman/CEO. The one year terms minimized the impact any one director could have on board decisions or the board decision-making processes. Fuld, in his capacity as CEO, was involved in significant financial decisions made by Lehman Brothers. He understood the importance of reducing leverage to maintain credit ratings (Valukas, volume 1, page 6) and the effect reporting losses would have on the company's survival (Valukas, volume 1, page 10). The bankruptcy report conclusion was that Fuld acted with gross negligence and breached the duty of care in filing misleading financial statements (Valukas, Volume 3, page 997). When questioned by examiners, Fuld denied knowing that Repo 105 transactions were used to remove assets from the balance sheets (Valukas, volume 3, pages 917-918). However, Fuld received documents and his assistant forwarded documents about Repo 105 (Valukas, volume 3, page 918) and the "balance sheet czar" (and later chief operating officer) recalled discussions with Fuld about the usage of Repo 105 transactions and the impact on trading decisions (Valukas, volume 3, pages 1000-1001).

He failed to inform other board members of the impact of Repo 105 transactions on financial statements and firm operations. When single transaction limits were removed, he failed to inform board members.

The FY 2007 proxy statement for Lehman Brothers states that the non-management members of the board were independent according to NYSE rules (Def 14a, March 28, 2008). The NYSE rules, adopted in 2003, stated that "more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation" is not independent (Final NYSE Corporate Governance Rules, 2003). In 2008, the NYSE direct compensation thresholds were increased to $120,000. At Lehman Brothers, the direct compensation was under $100,000 in FY 2007, but the deferred compensation, through generally stock options, increased the total compensation to over $300,000 for most directors. The stock options were exercisable in installments of 1/3 on the anniversary of the grant dates over the next three years, with ten year terms and were not forfeitable. Lehman developed categorical standards for determining independence and these were set forth in the proxy statement. The standards did not set limits on deferred compensation, other than requiring that the director (or immediate family member) not hold more than 5% equity ownership in the firm (or an associated company) (Def 14a, March 28, 2008, Appendix A, pages A1-A2). The standards tend to be couched in terms of materiality to the firm and not in materiality to the directors. Thus, transactions between directors and company were acceptable, as long as at arm's length and disclosed.

The audit committee had only one member as a financial expert. We question whether an audit committee with no members with experience in financial, investment services or banking, would, given the complexity of the Repo 105 transactions, be likely to discover the usage of Repo 105 through analysis of financial statements. It is not clear how an audit committee in proper communication with external auditors would have not known about such an important accounting policy. (The NYSE guidelines require the audit committee "to discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" (Final NYSE Corporate Governance Rules, 303a 7 (b) (iii) (B), page 11).) Once allegations of Repo 105 usage were made known, the audit committee appears to have acted appropriately. The audit committee was also responsible for oversight of the Finance and Risk committee (Final NYSE Corporate Governance Rules, 303a 7 (b) (iii) (B)).

The Finance and Risk committee initially did not know of the exclusions of investments from stress testing and did not identify the exclusions from review of the documents. The exclusions were significant, rendering the management reports meaningless; yet when later informed, some committee members believed the exclusions were reasonable. The committee met only two times in the year preceding the bankruptcy filing although at that time, financial conditions were worsening at Lehman Brothers. The director of the committee did not understand the importance of leverage in financial reporting. He considered a 4 or 5 point change in leverage as significant while the external auditors set the materiality threshold at 1/10 of 1% (Valukas, Volume 3, page 964).

Empirical Support for the Identified Weaknesses

The authors believe that many of the shortcomings in board oversight could have been remedied by (1) reducing the power of the CEO (2) increasing board member independence and (3) improving the expertise of board members. We provide empirical support for our findings.

Although studies have found a higher incidence of financial reporting fraud when duality exists (Beasley, 1996; Dechow et al., 1996, and Farber, 2005), the authors recognize the difficulty in changing the duality structure in US corporations. Desai et al., 2003 cited 80% of US firms with duality. (This percentage is also supported by Vo 2010) We note that increasing the terms for directors would have, in effect, increased the ability of non-management directors to question management decisions.

Board independence is the separation of board from management. As noted by Abbott et al., 2012, audit committee and board independence are important factors contributing to monitoring efficacy. Empirical research on the importance of committee and board member independence in financial reporting quality is mixed (Baber et al., 2006). We note differences in the measures of independence used by researchers. For example, Agrawal and Chadra,2005, consider board members to be independent when not insiders (employees) or gray directors. Zhang et al., 2007 measure independence by the percentage of outside directors. Abbott et al. 2004 takes a broader perspective measuring independence as a lack of disclosed affiliations, other than board service. The measure used in Abbott et al., 2004 more closely defines the scenario at Lehman Brothers where most of the directors had affiliations with Lehman Brothers. The study (Abbott et al., 2004) found that when audit committee members are not independent, there is an increased incidence of financial statement errors and irregularities.

At Lehman Brothers, the board was dependent on the firm for compensation. According to current NYSE rules, because most of the compensation was deferred, the compensation did not cause the board members to be deemed not independent. A study by Persons, 2012, finds when outside director's compensation is measured including stock options, there is a significant positive relationship between director compensation and fraud likelihood. When cash compensation alone is included was compensation, the relationship is not found. While stock options do promote increases in stock ownership, research suggests that the granting of stock options aligns director interests with those of management instead of shareholders. At Lehman Brothers, one third (all) of the gains from converting options to stock could be realized within one year (three years), suggesting the options were a convenient means to increase compensation to directors and still meet stock exchange independence requirements. We note here that for most corporations, stock options granted are fully exercisable in ten years (Malmendier and Tate, 2008). Thus, the short exercisability window of these options is unusual. Like the short terms for directors, this structure would tend to influence decision-making that maximized short-term versus long-term goals.

Another study, of particular relevance to the Lehman Brothers case, is that of Bouhosleh, 2009. This study included all traded firms with data from 1994-1998 and found the director's stock option to total compensation was positively related to reduced financial reporting quality. The granting of options tends to decrease management risk aversion (Chen et al., 2006). Yermack, 2004 found that the effect also extends to director stock options. Thus, the granting of stock options to directors at Lehman Brothers may also have contributed to the decreased risk aversion.

There are many studies that cite the importance of independent directors with accounting backgrounds serving on the audit committee (Abbott et al., 2004; Agrawal and Chadra, 2005; Farber 2005). Defond et al., 2005 finds that shareholders react positively to the appointment of financial experts. However, we find few that address the need for industry expertise. A study by Be'dard and Gendon, 2010 suggests that the ability to ask appropriately difficult questions is seen as a fundamental aspect to audit committee effectiveness. The study also finds that the ability to assess risk and industry knowledge important aspects for audit committee members. This is echoed by Kane and Steingraber, 2010 who suggest that understanding is critical to a director's ability to assess risk.

Finally, we also recognize that there appears to be some inter-relationships between the areas where we suggest improvements. For example, Abbott and Parker, 2000 notes that independent audit committees tend to also recognize the importance of accounting industry expertise, the auditor selected tends to be an industry specialist. Likewise, if the CEO is involved in the board selection process, the benefits of having an independent and expert audit committee are reduced (Carcello et al., 2011). According to the Lehman Brothers 2007 proxy statement, the nominating committee considered recommendations of the CEO in identifying potential board members, received feedback from the CEO once potential candidates were identified, and was involved in the interview process.

As noted by Cohen et al., 2008, an institutional theory approach rather than an approach based on strict adherence to regulatory requirements may be a more effective approach to understanding the effectiveness of corporate governance. At Lehman Brothers, the audit committee had a financial expert that did not understand materiality levels for leverage, the directors were deemed to be independent but compensation was generally over $300,000, and the CEO clearly would have been involved in the selection process of new directors (even though the nominating committee was deemed to be comprised of all independent directors).

Recommendations

Clearly the intent in NYSE rules which limit direct compensation is to provide for board independence. However, the exclusion of deferred compensation, particularly stock options with short exercisable windows should be addressed. Generally accepted accounting principles would call for the inclusion of stock options as compensation, yet the NYSE rules exclude it. Thus, we recommend that stock exchange rules should be amended to include all compensation, consistent with the accounting standards. By not increasing the total compensation requirements, this would in effect limit the offering of stock options. Other than the potential tax benefits, we see no reason why directors would prefer stock options over cash compensation.

The categorical standards for independence at Lehman Brothers were written from the firm's perspective, yet we note that other standards of independence, for example auditing standards, take the perspective from the individual whose independence is in question. For example, at Lehman Brothers, when a director is deemed independent, it should be whether the amounts would impact the ability of the director to separately identify from management not whether the amounts are significant to the company. Likewise, exchange rules should reflect the impact of compensation on director behaviors.

In our opinion, most of the failures in corporate governance in the audit committee and Risk and Finance committee relate to the lack of expertise of members. In the audit committee, a key committee at Lehman Brothers, that was also responsible for risk management oversight, only the chair of the committee was deemed a financial expert and he did not have industry experience in the complex financial instruments traded at Lehman Brothers.

Carcello and Hollingsworth, 2006 examined financial expert designations in the year following the Sarbanes Oxley required designations and found that most audit committee experts do not have a background in accounting or finance. Furthermore, the study found that 86% of those examined would not fit the definition of Defond et al., 2005, having accounting expertise or having been in the position of CEO or president. The chairman of the audit committee at Lehman Brothers had served as a CEO and in senior management positions in finance and accounting and was according to the definitions of both of these studies, a financial expert.

At Lehman Brothers, the Risk and Finance committee members did not identify that a significant amount of investments (and a significant amount of risk) was not accounted for in management reports. The director of the committee did not understand the importance of leverage to Lehman Brothers. The current approach of the SEC is of transparency. If investors are given biographies of directors in publicly available documents (such as annual reports and proxy statements) then market participants should be able to assess the abilities of directors. This market reward or punishment system clearly is not working as we found much of the information on director qualifications from publicly available sources. Thus, our recommendation is that boards should include a majority of directors who are industry experts on key board committees (such as audit or risk committees).

External Auditor Accountability

Audit of Lehman Brothers/ Auditing Standards in Place

Ernst & Young (E&Y) conducted the audit of Lehman Brothers for each of the three years ending on November 30, 2007, prior to the bankruptcy filing. The external auditors, E&Y, had knowledge of the usage of Repo 105 and its impact on financial statements (Valukas, Volume 3, pages 951, 953). While not proposing the practice, the auditors were "comfortable" with it (Valukas, Volume 3, pages 748, 750). E&Y reviewed the documents showing Repo 105 but they were satisfied that they met with accounting standards (presumably the GAAP rule SFAS 140) (Valukas, Volume 3, pages 951, 953). E&Y issued unqualified or clean audit reports prior to the bankruptcy filing.

The Valukas Bankruptcy report questions whether E&Y exercised "professional care" by failing to disclose Repo 105 practices to Lehman Brothers' audit committee. Complaints were made by Lehman top employees both to management and E&Y about the practice. (Valukas, Volume 3, pages 956-957). One day after a complaint was made to E&Y, the auditor met with the Lehman Brothers' Audit Committee and did not raise the subject (Valukas, Volume 3, page 959). At that time, auditing standards in place did not require the auditors to inform the audit committee of the Repo 105 practices as long as the auditors believed Lehman Brothers was not committing fraud, material misrepresentations, or illegalities (Valukas, Volume 3, page 1056). Therefore, whether E&Y was not correct in failing to inform the audit committee hinges on whether the client is believed to have committed fraud, material misrepresentations, or illegalities. The Valukas Bankruptcy Report suggests that the board of directors and outside disclosure counsel were unaware of the Repo 105 accounting usage and financial implications (Valukas, Volume 3, pages 855,945) and the auditors made no effort to inform the parties.

Subsequent Changes from the PCAOB

Effective for audits of fiscal years beginning on or after December 15, 2012, the Public Company Oversight Board (PCAOB) extended the auditing standards for communications with audit committees (AU No. 16, "Communications with Audit Committees").

The change most relevant to Lehman Brothers is in Section 12d which requires the auditor to communicate to the audit committee significant unusual transactions. Specifically,

"(1) Significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature, and

(2) The policies and practices management used to account for significant unusual transactions." (AU 16, 12d.)

Furthermore, if management fails to adequately communicate, the auditor should communicate and describe matters to the audit committee (AU 16 2d.)

Thus, under the new auditing standards, E&Y would have been required to communicate the use of REPO 105 transactions. However, the auditors are still not required to describe, inform, or educate as to the impact the transactions were having on the financial statements. Thus, industry expertise would have been needed for board members to understand the affects the transactions were having on financial presentation and risk exposure.

MD&A and Auditors Responsibility

At Lehman Brothers, the decision to increase the reliance on Repo 105 transactions impacted the way in which business was conducted. As noted by the Valukas report, Lehman Brothers should have disclosed the usage of Repo 105 transactions in the Management Discussion and Analysis (MD&A), a required part of the yearly 10-K (Valukas, Volume 3, pg. 969). The intent of the MD&A discussion is to provide "a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present"(SEC release 33-8350, 34-etc).

Certainly, the amount of transactions under Repo 105 and the positive effect on financial ratios would have affected investors' opinions about the long term situation, and indeed, the solvency of Lehman Brothers. Clearly, given the internal management discussion of the Repo 105 agreements (as documented in the bankruptcy filing), their importance in operations, and impact on financials should have been discussed. The discussion would have provided additional information in a public domain, specifically, "the context within which financial information should be analyzed"(SEC release 33-8350, 34-etc). Also MD&A requirements require the company "identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance…"(SEC Interpretations 17 C.F.R. 211, 231, 241). The MD&A would have provided additional information available to the board.

If the M D & A contains material inconsistencies, at a minimum, the audit firm should inform the audit committee if the client refuses to take corrective action (PCAOB AT Section 701.107). In contrast to the audit of financial statements, the auditor is not bound to attest in a publicly available letter that the MD&A provides a fair presentation. We would recommend something along the lines of a written statement of association that includes a requirement for reporting of significant items not disclosed, a statement on comparability and consistency in the key performance indicators (KPIs) provided, and more public disclosure of the communications between audit committees and auditors. In addition, if the auditor had been required to report on the effectiveness of risk oversight, the inadequacy of the risk reporting system might have been disclosed. We note that the auditor is required to assess risk in the general completion of the audit. Thus, reporting on the risk assessment mechanism within the firm could be a natural extension to the work of the auditor.

THE DODD FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

In response to the financial crisis and the failures of financial institutions, Dodd-Frank was signed into law on July 21, 2010. Had Lehman Brothers continued, the legislation would have impacted Lehman Brothers both directly and indirectly. Title I, The Financial Stability Act of 2010, created the Financial Stability Oversight Council charged with identifying risks to financial stability and responding to threats to the stability of the US financial system. The Council also monitors the financial services marketplace, of which Lehman Brothers was a participant. The council monitors accounting issues and provides advice to Congress and the Federal Reserve. As an investment market participant, several provisions would have directly impacted the day to day operations at Lehman Brothers, specifically trading in hedge funds (Title IV), credit default swaps (Title VII), and credit derivatives (Title VII), and disclosures to buyers of retail financial products or services (Title IX). After the demise of Lehman Brothers, Title II provisions would have directly impacted the way in which Lehman Brothers was liquidated. Under Title II, regulatory agencies would determine whether a receiver should be appointed.

The intent of Subtitle C of Title IX, Investor Protection and Securities Reform Act of 2010, is to improve the oversight of credit ratings agencies. In Subtitle C, the Act recognizes that credit ratings agencies "play a critical 'gatekeeper' role in the debt market that is functionally similar to that of securities analysts….and auditors, who review the financial statements of firms. Such role, justifies a similar level of public oversight and accountability (Title IX, Subtitle C (2).)"

Specifically, the intent of Subtitle C is to improve internal controls over credit ratings determination, improve independence in credit ratings agencies, provide annual reporting, and increase transparency (and consistency) in credit ratings. An Office of Credit Ratings was established to oversee credit rating agencies. The Office of Credit Ratings conducts annual reviews, provides inspection reports, and rule-making (including the setting of fines for noncompliance) of credit ratings agencies. Of particular relevance in Subtitle C is inclusion of information from sources, other than the issues or underwriter in credit ratings decisions. Thus, the deteriorating market conditions in the mortgage market, and in the securitized mortgage backed securities markets would have affected the credit rating of Lehman Brothers.

Lehman Brothers would also have been indirectly affected by the Dodd-Frank legislation. Specifically, these changes would have reduced the supply of mortgage backed securities and improved the quality of mortgage backed securities available for sale (Title IX, Subtitle D).

We do not argue that Dodd-Frank would have positively affected the way in which Lehman Brothers conducted business, primarily by limiting risk exposure (through enhanced regulatory and credit agency oversight and quality of mortgage backed securities). However, we find that many of the weaknesses we have identified would not be addressed in similar non-financial firms. This is because the primary focus of the Dodd-Frank legislation is on control of systematic risk from larger financial institutions and financial services companies (Dionne and Dionne, 2010). We argue in this paper that the weaknesses in the US financial reporting system disclosed in the bankruptcy of Lehman Brothers are pervasive in other non-financial industries that are largely not addressed in Dodd-Frank.

We note that certain provisions within the legislation also affect energy, utilities, mining, and CNR (natural resources) companies (Accenture, 2013). The impact on energy, utilities, mining, and CNR companies is in over-the-counter derivatives regulations, securitized debt, and enhanced capital standards (Accenture, 2013). For companies with significant debt, the credit ratings enhancements are intended to improve consistency and transparency in reporting. However, for many industries, the impact of Dodd-Frank is minimal.

We find that few of the provisions address our concerns with Lehman Brothers. Title IX, Subtitle E of the Investor Protection and Securities Reform Act of 2010 provides for shareholder vote on employee and CEO compensation, but does not include directors in the requirements. Disclosures to federal regulators of board incentive-based arrangements are required, but this is already provided within the proxy statements. Subtitle G of Title IX, requires statements as to why the same person serves as CEO and chairman of the board. This provision in no way provides that a company cannot have duality, merely that duality should be explained. Subtitle G also permits shareholder nomination of directors, thus strengthening the ability of shareholders to appoint/elect directors. Subtitle B of Title IX provides for increased whistleblower protection and incentives, however, we note much of the evidence collection in the Lehman Brothers bankruptcy filing was prompted by a whistleblower and this was before the enactment of Title IX. Subtitle E of Title IX provides for independence of compensation committees; however, in our analysis, we find the audit committee to be the critical board committee that failed to oversee financial reporting and risk assessment. Had the Repo 105 accounting treatment required a restatement, which in this case was not required because GAAP was followed, executive officers would have been required to recover incentive-based compensation under Dodd-Frank (Title IX, Subtitle E).

Our conclusion, then, is that the provisions of Dodd-Frank primarily affect the financial services (including investment and insurance) and banking institutions and investors (or participants) in those markets. Our analysis found failures that can be generalized to other industries Dodd-Frank fails to address.

SEC REGULATIONS AND SHAREHOLDER RIGHTS

As noted previously, the investors in Lehman Brothers were primarily holders of debt instruments. However, in many companies, the corporation is financed through equity offerings. Because we are considering the conditions at Lehman Brothers and what it says about US corporate governance, it is prudent to examine the changes in shareholder rights from the SEC. (The rules and subsequent court cases are more fully addressed by Jones and Smith, 2013.

In 2010, the SEC enacted two rules (Rule 14a-8 and 14a-11) to permit shareholders to more easily make nominations to the board of directors. Rule 14a-11 was struck down by the D.C. Circuit Court as "arbitrary and capricious." The Business Roundtable was the original plaintiff at the District Court level. The authority of Dodd-Frank seems to show that the SEC had the authority to pass both rules.

Empirical evidence was presented for both sides during the SEC rule-making process. While Rule 14a-11 was struck down by the D.C. Circuit, Rule 14a-8 was not challenged and provides an easier way to introduce shareholder input. The remaining Rule 14a-8 allows shareholders with $2,000 or more of shares to propose bylaws. The rule does not allow the current board to deny bylaws that would allow for a full slate of board members. If used, it would make it easier for independent boards to bar the type of fraud found in Repo-105. However, we note here that the shareholder activism is necessary for this change which would include the audit committee. A Delaware statute also provides the same "tools" for shareholders having more of a say about how corporations are run. (Most large corporations are incorporated in Delaware for historical reasons and so Delaware equity courts have large say in regard to the interpretations of Delaware's statutes).

Although the rules enacted by the SEC are an encouraging sign of changes in support of more management/board independence, the onus is on the shareholder who must be active in seeking changes to the board.

CONCLUSIONS AND LIMITATIONS

At Lehman Brothers, the practice of using Repo 105 transactions to bolster reported results had consequences for operations. As well documented in the bankruptcy report, traders were less disciplined and the firm took on more risk, arguably leading to a quicker bankruptcy filing. The board, weakened by lack of independence and financial expertise, missed warning signs that the risk assessment and restraining mechanisms were over-ridden. While events unfolded, financial statement readers (primarily debt issuers) and regulators were misled as to the true financial condition of the firm.

Auditors accepted financials based on strict interpretations of GAAP. Internal auditors warned of risk exposure but either reports were not heard by audit committee members or were not acted upon. The audit committee was not informed of the accounting treatment of Repo 105 transactions, although it was a significant accounting policy that materially impacted financial statement presentation. The auditors who had the eyes into the operations of the company did not effectively communicate concerns with the audit committee of the board of directors.

Standard setters and regulators acted swiftly after disclosure of the financial reporting. However, at this point, the firm had filed bankruptcy, investors had lost money, and the inter-relationships between Lehman Brothers and other investment firms contributed to the growing global financial crisis.

In this report, we find that weaknesses in the financial reporting environment contributed to the reporting failure. First, the internal corporate governance was weak. Exchange rules permitted directors with significant financial ties to be deemed independent. Most of the directors had been elected to the board after the CEO became chairman of the board. The nominating committee rules suggest the CEO’s involvement in the selection and nomination of the board members. The members of the Risk and Finance committee and audit committee lacked the specific industry experience to recognize key items, such as the exclusion of more than 78% of the losses in stress testing or the importance of leverage in financial reporting. Few members of the committees were financial experts. There appears to be a lack of communication between the audit committee and internal auditors, management, and external auditors. Internal auditors, external auditors, and management knew of and understood Repo 105 transactions, but the audit committee was not informed. The CEO who was also a board member had a duty to inform other members of the board, but neglected to do so.

Second, the auditor issued audit reports that would lead most investors to improper conclusions as to the financial condition at Lehman Brothers. The auditor followed the “letter of the law” in accepting the financials but certainly not the spirit (Jones and Presley 2012), accepting form over substance (Dutta et al. 2010), and may have been negligent in informing the audit committee of the whistleblower’s allegations (Valukas, Volume 3, page 945). However, the fault lies not with the auditor but with the standards of reporting. The auditor was not required to report the accounting treatment or to discuss the treatment with regulators. Although the ideal “eyes” into the operations (and indeed the attest function suggests the auditor should be reporting and opining), the auditor’s role is limited in what is reported and what is reported upon. Recent changes, particularly AU 16 have extended the auditor’s responsibilities, however, we feel by not enough.

Third, regulators were slow to respond. The SEC believed that problems might exist before Lehman Brothers was extensively relying on the Repo 105 transactions. The response was to make inquiries of management and not to aggressively pursue tighter reporting requirements and disclosures. The response that included a letter on MD&A reporting suggests the SEC is increasing emphasis on the importance of the MD&A, yet there is no attest function associated with MD&A reporting. FASB (once informed) did respond appropriately and swiftly, however, other weaknesses in reporting requirements likely exist. Again, the difficulty is not in the speed of response, but in the lack of knowledge of the existence and use of the gaps in accounting regulations (exploitation of "bright lines"). Clearly regulators need better eyes. If not the auditors, then others should inform regulators. The notion that a party using GAAP that is misleading would willingly inform either the SEC or FASB is not believable.

We examined the separate laws under Dodd-Frank and the potential impact the legislation would have had on Lehman Brothers. We find that, in general, Dodd-Frank is a post-crisis response specific to the financial services industry. Although the legislation increases oversight (potentially improving transparency and reducing the ability of firms in the financial services industries to window-dress financials) and reduces risk exposure (by regulating the amount and quality of mortgage-backed securities)--the two major factors in the bankruptcy of Lehman Brothers, there is minimal impact on non-financial firms. The central theme to our paper is that the events at Lehman Brothers can occur within other firms in other industries. The problems we identify are likely in other firms not addressed by the legislation and proposals.

There are a number of limitations in our analysis. We are reliant on the Valukas Bankruptcy Report and proxy statements for much of our analysis. While these are informative sources, there is the possibility that errors or omissions are in the reports. Much of the bankruptcy report is based on conversations subject to the recollections of the parties. Although we have identified areas for strengthening the financial reporting environment, we truly have no proof that our suggestions if implemented would prevent another Lehman-like event. We would like to hope that they would, but unless faced with the problems, we would not know if our suggestions for change would be effective. (For example, we would like to believe that an audit committee when informed that financials are materially misleading would not permit the financials to be issued and that finance and risk committees when informed that a significant portion of investments are excluded from risk assessment testing would require that they be included.) The ultimate goal is to have companies provide informative financial statements that are not misleading and this discussion brings us closer to that goal.

We also do not know what changes would be more successful and less costly. These issues were not addressed in this paper and we leave this discussion to other researchers. In some instances, our recommendations taken singly would likely have little impact. For example, researchers suggest that independence enhances reporting quality only if the directors were not selected by the CEO/chair (Carcello et al., 2011). Thus, our suggestion to improve independence might not be effective if the CEO continues to be involved in the director selection process.

We believe that this paper has added to the knowledge of why the Lehman Brothers Repo 105 transactions were done and in a larger sense, why earnings management and real activities management are common phenomenon. Although our discussion centered on Lehman Brothers, the weaknesses we identified and the recommendations we suggest are applicable to many publicly traded companies. Without changes in the current structure of corporate governance, we expect similar cases.

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APPENDIX A: SALE REQUIREMENTS UNDER SFAS 140

The accounting standard in place at the time Lehman used Repo 105, SFAS 140, permitted the recording of the debt transaction as a sale transaction. The rule contained three main requirements to determine the nature of the transaction. If the three requirements were met, the transaction could be recorded as a "sale"; otherwise, the transaction would need to be recorded as a collateralization. These requirements can be summarized as: (1) isolation of the transferred asset from the transferor; (2) the transferee has rights to pledge or exchange the assets with “no condition (that-sic) both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor”; and (3) “the transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47,49) or the ability to unilaterally cause the holder to return specific assets…”(Financial Accounting Standards Board (SFAS 140)).

In order for control over the assets to have been relinquished, the transferor (here, Lehman Brothers) “must have both the contractual right and the contractual obligation to reacquire securities that are identical to or substantially the same as those concurrently transferred. The transferor’s right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all the cost of purchasing identical replacement securities during the term of the contract.”(SFAS 140, par. 47-49, 217-218). This standard essentially assumes that the similarity in value of the transfers between the parties is a determinate of whether a sale has occurred. If the transfers are very similar, a sale has likely not occurred, but if the transfers differ, then a sale has likely occurred (SFAS 140 par 218).

“The Board also decided that the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults. Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline.” (SFAS 140 par 218

If the value of the assets surrendered were similar, according to accounting standards, the transfer is deemed to be of a temporary nature. The accounting treatment would be collaterialization and not a sale. Thus, by structuring the contract in a certain way, Lehman Brothers was able to meet one of the provisions of the accounting standard for recording the transaction as a sale.

Paragraph 218 of SFAS 140 set the requirement at as much as 98% collateralization for entities agreeing to repurchase and as little as 102% overcollateralization for securities lenders. The interpretation of the standard was that if it was between 98% and 102%, then this was close enough to being a transfer of similar assets to qualify as a collaterialization. Lehman Brothers set the amount at 105% (fixed income) or 108% (equity) in order to fall outside the limits, so that the repurchase was then accounted for as a sale. The quantification of the amounts in the accounting standards provided a means for parties to record the transaction as a sale or a collateralization, by setting the terms of the arrangement. An increase or decrease in transferred amounts by as little as 1% would trigger a different accounting treatment, provided the other conditions set forth in SFAS 140 were met.

In order for it to be a sale, legally the transaction must be viewed as a sale. According to the Valukas Bankruptcy Report, legal counsel did not consider the transaction as a sale transaction (Valukas, Volume 3, page 784). Indeed, Lehman Brothers was unable to find U.S. counsel that would support the transaction as a sale (Valukas, Volume 3, page 784). Therefore, if the transaction were conducted within the U.S., U.S. commercial law would not be supportive of it being a sale transaction. Specifically, there existed an agreement to repurchase. However, Lehman Brothers contended that transactions between parties not within the U.S. could be accounted for using the law in existence for one of the parties. For example, if London law would identify the transaction as a sale, the transaction could be recorded as a sale on the books of the entity falling under London law. U.S. standards are silent on the issue of foreign law and this appears to be a very liberal interpretation of the standard.