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An Ernst & Young Response to Audit Committee Member

Ernst & Young (EY LLP)

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An Ernst & Young Response: Dear Audit Committee Member...

By [Francine](#) • Mar 20th, 2010 • Category: [Food for Thought](#)

Ernst & Young (EY) is circulating a point-by-point response to the Lehman Bankruptcy Examiner's Report to Audit Committee Members. In the letter, EY attempts to defend their position in more detail.

I guess they know where their bread is buttered: With the guys who hire and fire them in the Fortune 500.

I will be commenting on this in more detail in a future post.

I obtained this note via an accounting professors listserv. [Dennis Beresford](#) sent it along to the list along with his comments, reprinted with his permission:

"In light of the extensive discussion of the Lehman Bros. and E&Y matter on this listserv over the past couple of weeks, I thought readers might be interested in the message I've copied below. This was sent to me in my capacity as an audit committee chairman. I hope this might balance the discussion somewhat. I would observe that to date the postings have been based mainly on newspaper accounts of the bankruptcy examiner's lengthy report that was completed for the purpose of determining whether the bankruptcy estate might have claims against various parties. In effect, basing one's conclusions about a situation on this source material is roughly equivalent to a judge or jury reaching a decision after hearing only the prosecution's side of the case. While the message below is necessarily very brief, I think it illustrates that there are other facts and arguments that should be fairly evaluated before anyone is found guilty in the court of public opinion or otherwise."

I hope this note finds you well and enjoying the early days of Spring.

In light of your role in our Audit Committee Leadership Network, I am sending you this note to brief you on a matter given there have been extensive media reports about the release of the Bankruptcy Examiner's Report relating to the September 2008 bankruptcy of Lehman Brothers. As you may have read, Ernst & Young was Lehman Brothers' independent auditors.

The concept of an examiner's report is a feature of US bankruptcy law. It does not represent the views of a court or a regulatory body, nor is the Report the result of a legal process. Instead, an examiner's report is intended to identify potential claims that, if pursued, may result in a recovery for the bankrupt company or its creditors. EY is confident we will prevail should any of the potential claims identified against us be pursued. We wanted to provide you with EY's perspective on some of the potential claims in the Examiner's Report. We also wanted to address certain media coverage and commentary on the Examiner's Report that has at times been inaccurate, if not misleading.

A few key points are set out below.

General Comments

· EY's last audit was for the year ended November 30, 2007. Our opinion stated that Lehman's financial statements for 2007 were fairly presented in accordance with US GAAP, and we remain of that view. We reviewed but did not audit the interim periods for Lehman's first and second quarters of fiscal 2008.

· Lehman's bankruptcy was the result of a series of unprecedented adverse events in the financial markets. The months leading up to Lehman's bankruptcy were among the most turbulent periods in our economic history. Lehman's bankruptcy was caused by a collapse in its liquidity, which was in turn caused by declining asset values and loss of market confidence in Lehman. It was not caused by accounting issues or disclosure issues.

· The Examiner identified no potential claims that the assets and liabilities reported on Lehman's financial statements (approximately \$691 billion and \$669 billion respectively, at November 30, 2007) were improperly valued or accounted for incorrectly.

Accounting and Disclosure Issues Relating to Repo 105 Transactions

There has been significant media attention about potential claims identified by the Examiner related to what Lehman referred to as "Repo 105" transactions. What has not been reported in the media is that the Examiner did not challenge Lehman's accounting for its Repo 105 transactions.

· As recognized by the Examiner, all investment banks used repo transactions extensively to fund their operations on a daily basis; these banks all operated in a high-risk, high-leverage business model.

Most repo transactions are accounted for as financings; some (the Repo 105 transactions) are accounted for as sales if they meet the requirements of SFAS 140.

· The Repo 105 transactions involved the sale by Lehman of high quality liquid assets (generally government-backed securities), in return for which Lehman received cash. The media reports that these were "sham transactions" designed to

off-load Lehman's "bad assets" are inaccurate.

- Because effective control of the securities was surrendered to the counterparty in the Repo 105 arrangements, the accounting literature (SFAS 140) /required /Lehman to account for Repo 105 transactions as sales rather than financings.

- The potential claims against EY arise solely from the Examiner's conclusion that these transactions (\$38.6 billion at November 30, 2007) should have been specifically disclosed in the footnotes to Lehman's financial statements, and that Lehman should have disclosed in its MD&A the impact these transactions would have had on its leverage ratios if they had been recorded as financing transactions.

- While no specific disclosures around Repo 105 transactions were reflected in Lehman's financial statement footnotes, the 2007 audited financial statements were presented in accordance with US GAAP, and clearly portrayed Lehman as a leveraged entity operating in a risky and volatile industry. Lehman's 2007 audited financial statements included footnote disclosure of off balance sheet commitments of almost \$1 trillion.

- Lehman's leverage ratios are not a GAAP financial measure; they were included in Lehman's MD&A, not its audited financial statements. Lehman concluded no further MD&A disclosures were required; EY did not take exception to that judgment.

- If the Repo 105 transactions were treated as if they were on the balance sheet for leverage ratio purposes, as the Examiner suggests, Lehman's reported gross leverage would have been 32.4 instead of 30.7 at November 30, 2007. Also, contrary to media reports, the decline in Lehman's reported leverage from its first to second quarters of 2008 was not a result of an increased use of Repo 105 transactions*. *Lehman's Repo 105 transaction volumes were comparable at the end of its first and second quarters.

Handling of the Whistleblower's Issues

- The media has inaccurately reported that EY concealed a May 2008 whistleblower letter from Lehman's Audit Committee. The whistleblower letter, which raised various significant potential concerns about Lehman's financial controls and reporting /but did not mention Repo 105/, was directed to Lehman's management. When we learned of the letter, our lead partner promptly called the Audit Committee Chair; we also insisted that Lehman's management inform the Securities & Exchange Commission and the Federal Reserve Bank of the letter. EY's lead partner discussed the whistleblower letter with the Lehman Audit Committee on at least three occasions during June and July 2008.

- In the investigations that ensued, the writer of the letter did briefly reference Repo 105 transactions in an interview with EY partners. He also confirmed to EY that he was unaware of any material financial reporting errors. Lehman's senior executives did not advise us of any reservations they had about the company's Repo 105 transactions.

- Lehman's September 2008 bankruptcy prevented EY from completing its assessment of the whistleblower's allegations. The allegations would have been the subject of significant attention had EY completed its third quarter review and 2008 year-end audit.

Should any of the potential claims be pursued, we are confident we will prevail.



[Francine](#) is

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14 Responses »

1. *Tenacious Truman* on [March 20th, 2010 at 9:40 am](#):

“Should any of the potential claims be pursued, we are confident we will prevail.”

Where have I heard that before? Hmm, let me see...

I heard it from Andersen regarding Enron in 2002.

I heard it from EY regarding Peoplesoft. I think that was 2004.

I heard it from PwC regarding Japan. I think that was 2006.

I heard it from PwC regarding India in 2009.

I'm sure Deloitte used the same line, and KPMG as well. Probably Grant Thornton too. I bet if you Google the right cases & press releases, you will see almost the exact same phraseology in every single instance.

I wonder if new CPA candidates need to memorize the line for the exam?

— Tenacious T.

2. *Terry Fox* on [March 21st, 2010 at 1:46 pm](#):

Read the book “Collosal Failure” if you want to know what really happened to Lehman Brothers. A more incompetent group never existed on Wall Street. E&Y is at most a side show in this tragedy.

3. [FT Alphaville » Further reading](#) on [March 22nd, 2010 at 1:50 am](#):

[...] “Dear Audit Committee [...]

4. [re: The Auditors » Blog Archive » Ernst & Young and Lehman Brothers: A Summary of Quotes, Stories and Links](#) on [March 22nd, 2010 at 11:23 am](#):

[...] An Ernst & Young Response: Dear Audit Committee Member... [...]

5. [jak25](#) on [March 23rd, 2010 at 8:27 am](#):

This is word for word the same as the conference call held for firm employees (non-partners) last Thursday.

6. [It's On: E&Y Fires Back, Says It Was All Lehman Management's Fault | Stocks!](#) on [March 23rd, 2010 at 10:29 am](#):

[...] the following list of rebuttals on a point by point basis, first reported by our friends at re:The Auditors and followed up by [...]

7. [re: The Auditors » Blog Archive » For The Auditors, Nothing's Over Until It's Over: Or Is It?](#) on [March 23rd, 2010 at 11:34 pm](#):

[...] I criticized Ernst & Young in mid-2008 for not questioning Lehman’s CFO revolving door. Lehman had chosen another non-CPA CFO, the second one in less than three years. I was following the lead of another Cassandra, David Einhorn. Einhorn is now being heralded because he questioned Lehman’s accounting, in spite of being ridiculed and damned for it at the time. He’s getting almost as much applause as the “whistleblower” du jour, Matthew Lee. [...]

8. [AS](#) on [March 24th, 2010 at 5:26 am](#):

yeah, I’ve heard this stuff so many times in the past few weeks, word for word. Even I could probably give the spiel these days.

9. [re: The Auditors » Blog Archive » The Case Against Ernst & Young: NYAG Cuomo Sues Over Lehman](#) on [December 22nd, 2010 at 8:11 am](#):

[...] they waited quite a long time to respond to the Lehman Bankruptcy Examiner’s report, too. They wrote letters to Audit Committee members – their bread and butter clients – members defending their actions, first. I had that [...]

10. [» Ernst & Young's Liability For Lehman Larger Than Claimed » Forex Trading Center | Sharing Rebate 100% – Fxkita.com](#) on [December 28th, 2010 at 12:15 pm](#):

[...] “Letter to Audit Committee Members” , issued privately right after the publication of the Lehman Bankruptcy Examiner’s Report in [...]

11. [Ernst & Young's Liability For Lehman Larger Than Claimed - Francine McKenna - Accounting Watchdog - Forbes](#) on [January 12th, 2011 at 8:06 pm](#):

[...] “Letter to Audit Committee Members” , issued privately right after the publication of the Lehman Bankruptcy Examiner’s Report in [...]

12. [re: The Auditors » Blog Archive » The Case Against Ernst & Young: NYAG Cuomo Sues Over Lehman](#) on [January 29th, 2011 at 6:53 pm](#):

[...] they waited quite a long time to respond to the Lehman Bankruptcy Examiner’s report, too. They wrote letters to Audit Committee members – their bread and butter clients – members defending their actions, [...]

13. [re: The Auditors » Blog Archive » 2011 Loeb Award Application: Beat Reporting](#) on [February 16th, 2011 at 12:31 pm](#):

[...] highlight of the series was the first publication of Ernst & Young’s initial response to the Valukas Bankruptcy Examiner’s report – a letter to Audit Committee members that was [...]

14. [re: The Auditors » Blog Archive » Going In Circles: A Few Remarks On Audit Reform](#) on [July 14th, 2011 at 11:55 am](#):

[...] explored the pros and cons of the issue. I was quoted and so were a few other notables such as Denny Beresford, who currently chairs the Audit Committees at Fannie Mae and Legg [...]

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• About the author

Francine McKenna (@retheauditors) has more than twenty-five years of experience in consulting and professional services including tenure at two Big 4 firms, both in the US and abroad. Look for my column, "[Accounting Watchdog](#)" at Forbes.com and "[Accountable](#)" at American Banker. For more information, click "About" at the bottom of this page. For more information contact Francine McKenna, fmckenna@mckennapartners.com

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