

# Financial Accounting Standards Board

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ROBERT H. HERZ  
Chairman

April 19, 2010

The Honorable Barney Frank, Chairman  
The Honorable Spencer T. Bachus III, Ranking Minority Member  
House Financial Services Committee  
2129 Rayburn House Office Building  
Washington, DC 20515

Re: Discussion of Selected Accounting Guidance Relevant to Lehman Accounting Practices

Dear Chairman Frank and Ranking Minority Member Bachus:

Thank you for the opportunity to submit an explanation of the accounting standards and relevant guidance relating to repurchase agreements for your April 20, 2010 hearing "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." In order to focus my response on the most relevant financial accounting guidance, I have referred to certain matters discussed in the report of the Lehman Bankruptcy Examiner.<sup>1</sup> Additionally, I have also provided a brief discussion of the relevant accounting guidance relating to consolidation of special-purpose entities, which I believe may be helpful to the Members of the Committee as they deliberate the public policy issues relating to Lehman's bankruptcy.

The FASB does not have regulatory or enforcement powers. However, whenever there are reports of significant accounting or financial reporting issues, we monitor developments closely to assess whether standard-setting actions by us may be needed. In some cases, a misreporting is due to outright fraud and/or violation of our standards, in which case accounting standard-setting action is not necessarily the remedy. Other cases reveal weaknesses in current standards or inappropriate structuring to circumvent the standards, in which case revision of the standards may be appropriate. In some cases, there are elements of both.

At this point in time, while we have read the report of the Lehman Bankruptcy Examiner, press accounts, and other reports, we do not have sufficient information to assess whether Lehman complied with or violated particular standards relating to accounting for repurchase agreements or consolidation of special-purpose entities. Furthermore, we do not know whether other major financial institutions may have engaged in accounting and reporting practices similar to those apparently employed by Lehman.

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<sup>1</sup> Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010.

In that regard, we work closely with the SEC. We understand that the SEC staff is in the process of obtaining information directly from a number of financial institutions relating to their practices in these areas. As they obtain and evaluate that information, we will continue to work closely with them to discuss and consider whether any standard-setting actions by us may be warranted.

However, in the meantime, this letter and its attachments summarize the current accounting and reporting standards relating to repurchase agreements and consolidation of special-purpose entities, including some of the recent changes the FASB has put in place.

#### *Accounting and Reporting Standards for Repurchase Agreements*

In a typical repurchase (repo) transaction, a bank transfers securities to a counterparty in exchange for cash with a simultaneous agreement for the counterparty to return the same or equivalent securities for a fixed price at a later date, usually a few days or weeks. Accounting standards prescribe when a company can and cannot recognize a sale of a financial asset based on whether it has surrendered control over the asset. In this context, two of the criteria key in determining whether a sale has occurred are:

- (a) The transferred financial assets must be *legally isolated* from the company that transferred the assets. In other words, Lehman or its creditors would not be able to reclaim the transferred securities during the term of the repo, even in the event of Lehman's bankruptcy.<sup>2</sup>
- (b) The company that transferred the assets does not maintain *effective control* over those assets. Specific tests relate to whether the company has maintained effective control, which are described below.

If both of these criteria are met (among other criteria), the repo would be accounted for as a sale. If either of these criteria is not met, the repo would be accounted for as a secured borrowing. As a general matter, most standard repo transactions fail one or both of these criteria and, therefore, are accounted for as financings.

In the case of repos, one of the relevant tests for assessing effective control relates to the amount of cash collateral that has been provided, relative to the value of the securities transferred. The rationale behind this condition is that the counterparty has promised to return the securities, but even if it defaults, the arrangement provides for sufficient cash collateral at all times, so that the company could buy replacement securities in the market.

My understanding of Lehman's Repo 105 and 108 transactions is based on what I have read in the Examiner's report, press accounts, and other reports. Lehman apparently engaged in

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<sup>2</sup> The Audit Issues Task Force Working Group of the AICPA issued an Auditing Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 140," to assist auditors in their analysis. I have separately provided a copy to the Committee staff.

structured transactions, known within Lehman as “Repo 105” and “Repo 108” transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days. Lehman reported its Repo 105 and Repo 108 transfers as sales rather than secured borrowings. The cash received in the transfers was used to pay down liabilities.

Lehman reported its Repo 105 and Repo 108 transactions as sales rather than secured borrowings, apparently by attempting to structure the transactions so as to try to support the following conclusions:

- (a) That the transferred securities had been legally isolated from Lehman (based on a true sale opinion from a U.K. law firm), and
- (b) That the collateralization in the transactions did not provide Lehman with effective control over the transferred securities.

Based on the Examiner’s report, Lehman’s Repo 105 and Repo 108 transactions were structurally similar to ordinary repo transactions. The transactions were conducted with the same collateral and with substantially the same counterparties.<sup>3</sup>

Additionally, the following two points may be relevant to the analysis of Lehman’s accounting for Repo 105 and Repo 108 transactions.

First, the assessment of legal isolation may have only considered whether the securities were isolated from a U.K. subsidiary, as opposed to the consolidated U.S. entity. We understand that, at least in some cases, the securities were first transferred from a U.S.-based entity to a U.K. subsidiary, and were then repoed with a counterparty in the U.K. Attorneys have told us that there are significant legal differences in how repo transactions are viewed in the event of the insolvency of a repo seller under U.S. and English laws. In the United States, case law related to repurchase transactions has been varied enough that most attorneys generally would not provide a true sale opinion. In England, there is apparently significantly less uncertainty about how a transfer related to a repo would be viewed by a court of law in the event of the insolvency of the repo seller (transferor). Under English law, a transfer in which the documents clearly demonstrate a seller intends to transfer outright to the buyer his entire proprietary interest in an asset apparently would be considered a true sale.

We understand that the opinion prepared by the English law firm may have limited applicability and pertains only to the portion of the transaction executed by the U.K. subsidiary with the repo counterparty. It is not clear that claims could not be pressed in another jurisdiction such as the U.S., since the securities were registered in the U.S. and it is not clear whether the transfer from Lehman to its U.K. subsidiary would be deemed to be a true sale under U.S. law. It is also not clear that the transfers would have resulted in isolation (including in bankruptcy) of the transferred assets from the consolidated Lehman entity, not

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<sup>3</sup> Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010, v3, pg. 746.

just the U.K. subsidiary, and thus any legal analysis would likely need to address all relevant jurisdictions including U.K. and U.S. law.

Second, with respect to the level of collateralization in the arrangement, Lehman apparently took a discount on the face value of the transferred assets (known as a “haircut”) offered to the counterparty. Instead of transferring approximately \$100 worth of securities for every \$100 of cash received, Lehman transferred \$105 worth of debt securities or \$108 of equity securities for every \$100 in cash received (hence, the names Repo 105 and Repo 108). It appears that Lehman structured the transactions in an attempt to support a conclusion that there was inadequate cash collateral to ensure the repurchase of the securities in the event of a default by the counterparty, and, on that basis, Lehman determined that sale accounting was appropriate. Under sale accounting, Lehman

- (a) Removed the transferred securities from its balance sheet,
- (b) Recognized the cash received, and
- (c) Recognized the difference (\$105 or \$108 securities derecognized less \$100 cash received) as a forward purchase commitment.

When developing the guidance for determining whether a company maintains effective control over transferred assets, the FASB noted that repo transactions have attributes of both sales and secured borrowings. On one hand, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning the asset. On the other hand, the contemporaneous transfer and repurchase commitment entered into in a repo transaction raises questions about whether control actually has been relinquished. To differentiate between the two, the FASB developed criteria for determining whether a company maintains effective control over securities transferred in a repo transaction.

As noted above, one of those criteria requires a company to obtain adequate cash or collateral during the contract term to be able to purchase replacement securities from others if the counterparty defaults on its obligation to return the transferred securities (“collateral maintenance requirement”). The accounting guidance provides the following example of a collateral maintenance requirement that does maintain effective control:

Arrangements to repurchase securities typically with as much as 98–102% collateralization, valued daily and adjusted up or down frequently for changes in market prices, and with clear powers to use that collateral quickly in the event of the counterparty’s default, typically fall clearly within that guideline.

The accounting guidance emphasizes the need for understanding the terms of a repo agreement and applying judgment in other situations to determine whether a company maintains effective control over the transferred securities. That example was not intended to, nor does it, create a “bright-line” for making that determination. Rather, the example describes typical collateral arrangements in repurchase agreements involving marketable securities indicating that these typical arrangements clearly result in the transferor maintaining effective control over the transferred securities.

The accounting guidance for repos has been in place since 1997 and has not been changed significantly over the years.

When there are material structured or unusual transactions, disclosure is also very important. The Examiner's report indicates that Lehman's disclosure was incorrect and misleading. According to the Examiner's report, Lehman disclosed that it accounted for all repos as secured borrowings.

#### *Accounting and Reporting Standards for Consolidation of Special-Purpose Entities*

A recent press account indicates that Lehman used a small company run by former Lehman employees apparently to shift investments off its books.<sup>4</sup> Based on that press account, it is not possible to determine whether that company was an operating business or a special-purpose entity (SPE). Although the press account does not describe whether and how the presence of related parties may have affected Lehman's consolidation analysis, consolidation accounting standards require consideration of related parties and de-facto agents in the consolidation analysis. In addition, accounting standards require companies to disclose significant related party transactions and de-facto agent arrangements.

The financial crisis revealed that accounting standards governing which entity must recognize and report interests in SPEs were inadequate to protect against "surprise" risks to institutions that had treated these entities as "off balance sheet." Before the recent changes to the accounting standards on consolidation described below, certain entities were exempt from consolidation requirements. Those exemptions assumed that some SPEs (including mortgage trusts) could function on "autopilot," in which no entity was deemed to be in control of such SPEs. This assumption has not been borne out in the recent period of severe stress in the mortgage market. Consolidation requirements before the recent changes had a simple concept that a company should consolidate an SPE if it has the majority of risks and/or rewards of that entity. However, the implementation of this concept was effected through complex mathematical calculations that often excluded the effect of key risks such as liquidity risk. With the benefit of hindsight, it seems that judgments were made based on overly optimistic forecasts of returns and risk, enabling companies to avoid consolidating entities in which they retained significant continuing risks and obligations. While there were numerous required disclosures under generally accepted accounting principles and SEC rules, many financial companies failed to clearly disclose retained risks, obligations, and involvements with SPEs.

Also, with the benefit of hindsight, it appears that arrangements were structured to achieve the desired outcomes of removing financial assets and obligations from balance sheets and reporting lower ongoing risk and leverage. From an investor's viewpoint, this obfuscated important risks and obligations.

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<sup>4</sup> Article in New York Times on April 13, 2010, titled *Lehman Channeled Risks Through "Alter Ego" Firm*.

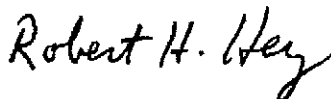
To address this, the FASB, at the request of the SEC, completed targeted projects that resulted in removing the exemption for certain entities from consolidation requirements (FAS 166 on transfer of financial assets) and in tightening the requirements governing when such entities should be consolidated (FAS 167 on consolidation of variable interest entities). In addition, the FASB enhanced disclosure requirements to improve disclosure of a company's involvements with transferred financial assets and SPEs. FAS 166 and 167 were issued in June 2009 and became effective in January 2010.<sup>5</sup> The enhanced disclosure requirements became effective in December 2008.

Under FAS 167, entities with the power to control key decisions and the exposure to risks and rewards will more likely report the assets and liabilities on their financial statements. FAS 167 requires an entity to provide enhanced disclosures about its continuing involvement with an SPE, regardless of whether that SPE is on- or off-balance sheet. Along with disclosures about the judgments used in assessing control and evaluating ongoing returns and risk, the revised accounting will put investors in a better position to determine who will ultimately bear the losses and reap the rewards of SPEs.

We are currently working with the International Accounting Standards Board (IASB), which promulgates International Financial Reporting Standards that are used in a number of other jurisdictions, to develop a joint standard on derecognition of financial assets, and the accounting for repurchase agreements is being considered. We are also working with the IASB to develop a joint standard relating to consolidation policy that would apply to traditional operating entities as well as SPEs. We stand ready to consider any further standard-setting actions that may be necessary.

Thank you for the opportunity to provide information on these important issues. FASB members and members of our technical staff would be pleased to respond to further inquiries or to discuss these matters further with you and your staff.

Sincerely,



Robert H. Herz  
Chairman

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<sup>5</sup> I have separately provided a copy to the Committee staff.