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One Problem, Three Fixes

The FASB, the IASB, and the SEC have each responded differently to the Repo 105 financial-reporting controversy. Their rule changes will affect many reporting entities.

The Financial Accounting Standards Board (FASB) recently issued a proposed Accounting Standards Update (ASU) intended to close a problematic loophole in U.S. Generally Accepted Accounting Principles (GAAP). The FASB's action is a direct response to the "Repo 105" controversy, which revolves around a specific financial-reporting practice that has received much attention since being highlighted in a report issued earlier this year by the court-appointed bankruptcy examiner of Lehman Brothers Holdings, Inc. (Lehman). The U.S. Securities & Exchange Commission (SEC) has also responded to the controversy by proposing a change to its rules. And the International Accounting Standards Board (IASB) has responded by amending International Financial Reporting Standards (IFRS).

In this month's column, I'll explain:

- The problem at the center of the Repo 105 controversy;
- The three different approaches that the SEC, the IASB, and the FASB have taken to fix the problem; and
- The impact the fixes will have on reporting entities of all kinds.

A Look at Lehman

The Repo 105 controversy is best understood within the context of Lehman's bankruptcy—the largest ever to have occurred in the United States. From a modest start in 1850 as a retailer of textiles and clothing in Alabama, Lehman evolved into a global financial-services giant whose major lines of business included investment banking, securities brokerage, and investment management. Just before declaring bankruptcy in September 2008, Lehman was heavily exposed to the risks associated with residential-mortgage loans receivable. Significant declines in the market values of its mortgage-related assets paved the way for its collapse. At the time it filed for debtor-in-possession reorganization (Chapter 11) in the U.S. Bankruptcy Court for the Southern District of New York, Lehman owed $613 billion to its creditors.

In January 2009, the Court appointed Anton R. Valukas, chairman of the law firm Jenner & Block LLP, to examine Lehman's bankruptcy. On March 11, 2010, Valukas issued his 2,200-page examiner's report. A portion of the report focused on certain transactions occurring in the fourth fiscal quarter of 2007 and the first and second fiscal quarters of 2008. Those transactions involved Lehman transferring marketable securities to counterparties in exchange for cash, subject to repurchase agreements ("repos") between Lehman and the counterparties.

Accounting for Repos

A repo typically accompanies a transfer of financial assets when the transferor wants to maintain ownership of the assets in the long term but needs cash to use in the short term. Initially, financial assets are transferred from one entity to another in exchange for an amount of cash that's slightly smaller than the value of the transferred assets. After a stipulated period of time (which could range from one day to several months), the original transferor is obligated to repay the cash to the original transferee along with an agreed-upon amount of additional cash. At that time, the original transferee is obligated to return the financial assets to the original transferor. Taken together, such transactions constitute a short-term loan of cash from the original transferee to the original transferor. The transferred assets serve as collateral to secure the loan in the event that the borrower (the original transferor) is unwilling or unable to repay the lender (the original transferees).

In the years leading up to Lehman's bankruptcy, the provisions of U.S. GAAP applicable to a transfer of financial assets undertaken in conjunction with a repo were documented in Statement of Financial Accounting Standards (SFAS) No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS No. 140, which had been issued by the FASB in September 2000, prescribed an approach to determining which of two accounting treatments to apply to such transfers. In most cases, the transferor would account for the transferred assets as collateral pledged to secure a cash loan from the transferee. In some cases, however, the transferor would account for the transfer as a sale of assets for cash. Specifically, the transferor could account for a repo-accompanied transfer as a sale rather than as a secured borrowing if the value of financial assets transferred was more than 102% of the amount of cash received.

The 105-Percent Solution

Hoping to avoid bankruptcy proceedings, Lehman executed a series of carefully planned financial-asset transfers and repurchases in order to temporarily reduce short-term debt on its balance sheet precisely when it was most advantageous to do so. The 102% "bright line" in SFAS No. 140 played a key role in Lehman's scheme.

Just before the end of each quarterly reporting period, Lehman transferred marketable securities to an unrelated counterparty in exchange for cash, simultaneously agreeing to repurchase the securities from the counterparty within a matter of days. Because the securities that would eventually be repurchased were valued at 105% or more of the cash received (hence the nickname "Repo 105"), Lehman accounted for the transfers as sales under SFAS No. 140. Lehman used the cash it obtained to pay down a significant portion of its sizable short-term debt. Then, shortly after each quarter close, Lehman incurred new short-term debt to raise the cash needed to repurchase the transferred securities from the counterparty.

As a result of the nature, timing, and accounting treatment of the Repo 105 asset-transfer and debt-reduction transactions, neither the transferred financial assets nor the cash received in exchange for them appeared on Lehman's balance sheet at quarter-end. More importantly, Lehman showed less short-term debt on its balance sheet at quarter-end than it would have had it not engaged in the Repo 105 transfers and paid down a portion of its short-term debt. Shortly after each quarter-end balance-sheet date, Lehman's short-term debt returned to its previous level, and the marketable securities once again appeared on the firm's balance sheet as a result of Lehman incurring new short-term debt to raise cash and using the cash to repurchase the transferred securities.

To fully understand the role of U.S. GAAP in Lehman's scheme, we must examine the other possible accounting treatment for repo-accompanied transfers of financial assets under SFAS No. 140. Had Lehman been required to account for each Repo 105 asset transfer as a secured borrowing rather than as a sale:

- The transferred securities would have remained on Lehman's balance sheet because they would have been considered pledged collateral for a loan rather than permanently liquidated assets.
- Immediately after each initial transfer, the cash Lehman received from the counterparty would have appeared on Lehman's balance sheet along with a short-term loan payable to the counterparty.
- Once Lehman used the cash to pay down other short-term debt, Lehman's total short-term debt would have been the same as it was before the asset-transfer and debt-reduction transactions.
- Reversing these transactions after the quarter close would likewise have had no net effect on Lehman's total short-term debt.

Thus, there would have been no point in engaging in the Repo 105 transactions had Lehman been required to account for them as secured borrowings. And the sole point of engaging in the Repo 105 transactions, given that they were accounted for as sales, was to portray an inaccurately favorable picture of Lehman's financial situation.

Did It Really Matter?

As a result of its Repo 105 scheme, Lehman was able to temporarily reduce its reported debt

- By $38.6 billion in the fourth fiscal quarter of 2007,
- By $49.1 billion in the first fiscal quarter of 2008, and
- By $50.4 billion in the second fiscal quarter of 2008.

These temporary, material reductions in reported debt also resulted in temporary, material reductions in Lehman's reported financial leverage, which was significantly lower at the end of each of the three quarters than it typically was during the quarters. For example, Lehman's net financial leverage (essentially the ratio of total assets to total equity) was 12.1 at the end of the second fiscal quarter of 2008. Without the Repo 105 scheme, Lehman's leverage would have been 13.9.

For investors and creditors attempting to accurately assess the financial risk to which they are exposed, differences like that matter—a lot. Yet Lehman didn't disclose its Repo 105 transactions, its accounting treatment for them, or the material effect they had on the company's reported debt and leverage. Based on the information that Lehman did make available, users of Lehman's financial statements were effectively misled into thinking that the firm's financial risk was significantly lower than it really was. Within the context of capital markets, such an outcome is inconsistent with the public interest.

"Window Dressing" or Deception?

Some observers have asserted that what Lehman did amounts to nothing more than end-of-period "window dressing" that's understood to be common practice among listed companies. The implications are that "everybody knows everybody does it" and that investors and creditors factor such knowledge into the pricing of their capital.

But other observers point out that even if window dressing is common practice, it's possible for a reporting entity to take it too far. As an analogy, let's say you invite guests to your home. You'll probably clean and straighten up a bit before your guests arrive. Maybe your home doesn't always look so neat and tidy, but no guest will think that you're a "phony" because the carpet is clean and the sofa cushions are neatly arranged when they visit. On the other hand, if you borrow you brother's fancy car to park in your driveway and serve your guests cheap liquor from the bottle of an expensive brand that you kept after consuming its original contents, then it's a different story.

From a policy perspective, accounting standards setters and regulators are challenged to prevent window dressing from becoming deception. But before examining how the SEC, the IASB, and the FASB have addressed this challenge, it's important to note what the Repo 105 problem was *not*:

- The securities involved in Repo 105 transactions were *not* "toxic" or "junk." In fact, they were some of the highest-quality securities Lehman owned.
- Repo 105 transactions did *not* cause or contribute to Lehman's bankruptcy. Lehman was slightly worse off for having borne avoidable interest and transaction costs, but not to a meaningful extent.
- Lehman did *not* violate the "letter" of U.S. GAAP in accounting for the Repo 105 transactions.
- Lehman did *not* attempt to hide its Repo 105 transactions from auditors or regulators.

The SEC's Response

The revelations about Repo 105 in the Lehman bankruptcy examiner's report caught the SEC by surprise. In late March 2010, the SEC sent a "Dear CFO" letter to the chief financial officers of several public companies, requesting information about transactions involving the transfer of financial assets accompanied by repos. The SEC wanted to know the extent to which companies engaged in transactions involving repos, how companies accounted for those transactions, the difference the transactions made in reported financial information, and what disclosures companies made regarding them.

At its September 17, 2010, meeting, the SEC voted unanimously to issue Release No. 33-9143, which proposed rules that would require public companies to disclose additional information about their short-term-borrowing arrangements, regardless of how such arrangements are accounted for. Also at that time, the SEC voted to issue an interpretive release (No. 33-9144) that provides guidance on existing disclosure requirements pertaining to liquidity and funding.

The new disclosure requirements would enable users of a reporting entity's financial statements to compare average and maximum levels of short-term debt during each quarterly reporting period to quarter-end levels. Such disclosures would severely limit a reporting entity's ability to mislead users of its financial statements by artificially and temporarily erasing debt from its balance sheet at quarter-ends.

Note that the SEC hasn't proposed prohibiting transactions like Lehman's Repo 105 transactions, nor has it proposed different accounting for such transactions. From the SEC's perspective, additional disclosure is the appropriate response to the Repo 105 controversy.

The IASB's Response

Shortly after the Lehman bankruptcy examiner's report was issued, IASB Chairman Sir David Tweedie responded to a media inquiry regarding whether IFRS allows reporting entities to account for repo-accompanied transfers as sales and thus enable reporting entities to distort the balance sheet through transactions in the style of Repo 105. Sir David's response was "We don't allow it. That's why we have principles, not rules, so you can't do it" ("Accounting Boards to Work on Repo Transactions," AccountingToday.com, April 7, 2010).

Apparently over the next six months, the IASB came to feel less confident than Sir David about whether adhering to the existing principles of IFRS would preclude reporting entities from misleading users of its financial statements the way Lehman did. So on October 7, 2010, the IASB amended IFRS 7, "Financial Instruments: Disclosures," to require additional disclosures if a disproportionate amount of financial-asset transfer transactions are undertaken around the end of a reporting period.

The IASB's response is both similar to and different from the SEC's response. Similar in the sense that both the SEC and the IASB decided to require additional disclosures about certain transactions rather than changing the accounting treatment for them. Different in the sense that the IASB's newly required disclosures focus on the transactions themselves in contrast to the SEC's focus on the impact of the transactions on the entity's financial statements.

The FASB's Response

On November 3, 2010, the FASB issued an exposure draft (ED) of a proposed change to U.S. GAAP. The change would eliminate from consideration the criterion that enabled Lehman to account for its Repo 105 transactions as sales and therefore would make sales treatment of repo-accompanied financial-asset transfers less likely. The FASB's proposed change thus closes the key loophole in U.S. GAAP that Lehman relied on when perpetrating its deception.

The FASB's response differs markedly from the SEC's and the IASB's responses. Specifically, the change the FASB proposed to U.S. GAAP would alter the accounting treatment applied to transactions like Lehman's Repo 105 transactions without requiring any additional disclosures. The affected provisions of U.S. GAAP, which originated in SFAS No. 140, are now located in Topic 860, *Transfers and Servicing*, of the FASB's *Accounting Standards Codification*™.

Impact on Reporting Entities

The impact of the SEC's, the IASB's, and the FASB's actions will be widespread. Reporting entities that are SEC registrants would be required to disclose additional information regardless of whether they are "financial" entities and regardless of whether they engage in repo-accompanied financial-asset transfers. Any entity that reports under IFRS is required to disclose additional information of a different kind. And any public or private entity that reports under U.S. GAAP would apply a modified process for determining the appropriate accounting treatment for any repo-accompanied financial-asset transfers that it undertakes.

What's Next?

In the case of Repo 105, Lehman chose to engage in transactions that, when accounted for in accordance with U.S. GAAP, served no purpose other than to mislead users of Lehman's financial statements in a significant way at a significant time. In the United States, conformance to U.S. GAAP is presumed to result in "fair presentation" of an entity's financial situation. So what constitutes appropriate action by auditors,

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standards setters, regulators, or users of financial statements when reality refutes that presumption?

Unfortunately, there's no simple answer to that question. As we've seen, the FASB, the IASB, and the SEC each formulated a different response to the Repo 105 controversy. As a result of those responses, virtually all participants in the financial reporting supply chain will have to digest new and different rules because one reporting entity was caught abusing the old ones. This has happened before, and we're likely to see it happen again when the next loophole is uncovered. **SF**

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