Statement by

Anton R. Valukas

Examiner, Lehman Brothers Bankruptcy

before the

Committee on Banking, Housing, & Urban Affairs

Subcommittee on Securities, Insurance, and Investment

United States Senate

regarding

The Role of the Accounting Profession in Preventing Another Financial Crisis

April 6, 2011

Anton R. Valukas is the Chairman of Jenner & Block. He has substantial experience in major civil and white collar criminal litigation and independent investigations. Mr. Valukas has served in several positions in the U.S. Department of Justice, including as the United States Attorney for the Northern District of Illinois (1985 through 1989), Assistant United States Attorney (1970-1974), Chief of the Special Prosecutions Division (1974), and First Assistant United States Attorney (1975-1976). In 2009, Mr. Valukas was appointed as the Examiner in the Lehman Brothers Holdings bankruptcy proceeding. The Examiner's Report was released on March 11, 2010. The views expressed in this testimony are Mr. Valukas' personal views and do not necessarily reflect the views of Jenner & Block or its clients.

Dear Chairman Reed, Ranking Member Crapo, and Members of the Committee:

I appreciate the opportunity to appear before you to address what role the accounting profession can play in helping to prevent another financial crisis. I address this question primarily from the perspective of my role as the Examiner in the Lehman Brothers bankruptcy proceeding.

I want to emphasize at the outset that I did not make any finding as to whether regulators or auditors necessarily could have prevented Lehman's collapse. Lehman failed in part because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity. Lehman was unable to maintain confidence because it made a series of business decisions that left it with heavy concentrations of illiquid assets with deteriorating values, such as residential and commercial real estate. The extent to which Lehman's demise was, in part, the function of any act or failure to act by the auditors is a question we must leave for the courts.

Lehman's executives – not regulators or auditors – made the decision to load up on illiquid assets. Lehman's executives – not regulators or auditors – were responsible in the first instance for preparing fair and accurate financial reports. I found that Lehman's decision not to disclose to the public a fair and accurate picture of its financial condition gave rise to colorable claims against senior officers who oversaw and certified misleading financial statements.

Nevertheless, and wholly apart from the claims involving Lehman's auditors, we must recognize the general principle that auditors serve a critical role in the proper functioning of public companies and financial markets. Boards of Directors and audit committees are entitled to rely on external auditors to serve as watchdogs – to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a "clean" report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat.

I found that colorable claims exist against Lehman's external auditor in connection with Lehman's issuance of materially misleading financial reports. As I explained in my Report:

> [I]n this Report a colorable claim is one for which the Examiner has found that there is sufficient credible evidence to support a finding by a trier of fact. The Examiner is not the ultimate decision-maker; whether claims are in fact valid will be for the triers of fact to whom claims are presented. The identification of a claim by the Examiner as colorable does not preclude the existence of defenses and is not a prediction as to how a court or a jury may resolve any untested legal, factual, or credibility issues.

If Lehman had earlier presented a fair and accurate picture of its financial condition, regulators and Lehman's Board may have had a fighting chance to make needed corrections or arrange for a smoother landing. As there is litigation pending against some of the individuals and entities covered by my findings, it would not be appropriate for me to comment directly on any issues that will have to be decided by the courts. There are, however, important lessons that can be gleaned as to how auditors can help prevent another financial crisis.

In Lehman's final months, two issues were of critical importance: leverage and liquidity. In both instances the system broke down. Information given to the investing public was misleading or inaccurate, and opportunities to identify severe problems were missed.

Leverage: Lehman's Balance Sheet Manipulation

Beginning in 2007, market observers began demanding that investment banks reduce their leverage. Lehman knew that if it did not reduce leverage it would suffer a ratings downgrade, which would have an immediate and tangible monetary impact. Paolo Tonucci, Lehman's Global Treasurer, recognized in 2007 that ratings agencies were "most interested and focused on leverage." In early 2008, Erin Callan, Lehman's CFO, noted that reducing leverage was necessary to "win back the confidence of the market, lenders, and investors."

Lehman's CEO Richard Fuld knew that Lehman had to improve its net leverage ratio by selling inventory, but by mid-2007, much of Lehman's inventory had become "sticky" – difficult to sell without incurring substantial losses. As detailed in my Report, Lehman opted to create a *perception* of reducing its net leverage ratio through increased use of a device known as "Repo 105."

Lehman repeatedly and heavily relied on Repo 105 transactions to temporarily remove – and I emphasize *temporarily* – some $50 billion off of Lehman's balance sheet right at quarter end. Lehman undertook $38.6 billion, $49.1 billion, and $50.38 billion of Repo 105 transactions at quarter-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively. Lehman executives described this accounting device as a "gimmick," "window dressing," and a "drug we r on." Martin Kelly, Lehman's former Global Financial Controller, stated unequivocally that there was "no substance to the transactions." *$50 billion of transactions with no business purpose*. I uncovered ample contemporaneous evidence that the sole purpose of these transactions was to make the published balance sheets look better than they actually were. To make matters worse, these transactions not only lacked any affirmative business purpose but required Lehman to pay a premium for the privilege of masking its true financial condition.

Without getting into specifics as to contested issues that might be involved in litigation, there is no serious dispute that Lehman's external auditor was aware of Lehman's Repo 105 accounting policy and was aware of an allegation that Lehman had used that policy to move $50 billion temporarily off the books at quarter end.

Lehman did not publicly disclose that it used $50 billion of these transactions at quarter end. Whether due to gaps in professional audit standards or a failure to follow those standards, the result is the same: the external auditor did not object when Lehman omitted any reference to these transactions in its public filings.

I found colorable claims that Lehman did not merely mislead by omission. Lehman represented to the investing public that it had worked to lower its net leverage ratio: Lehman stated in its Management Discussion and Analysis ("MD&A") that net leverage is "more meaningful" than a simple leverage ratio. Lehman's statement that the net leverage ratio was a "more meaningful" measurement of leverage was misleading because that ratio was not an accurate indicator of Lehman's actual leverage, and in fact, understated Lehman's leverage significantly. I found that sufficient evidence exists for a judge or jury to find that Lehman's reported net leverage ratio was materially misleading.

In analyzing what steps could help avoid similar misstatements or omissions in the future, it should be noted that rules in place at the time required that an MD&A include an analysis of known material trends, events, demands, commitments, and uncertainties. Existing regulations required registrants to discuss known trends involving their liquidity and capital resources, *specifically including off-balance sheet financing arrangements*. The same regulations specified that a registrant should discuss, among other things, the "nature and *business purpose* to the registrant of such off-balance sheet arrangements." As we have seen, Lehman's off-balance sheet arrangement had no business purpose. Lehman did not so advise the public.

SEC guidance also stated that an MD&A should describe "unusual events and transactions" to help identify apparent trends. Lehman did not disclose the unusual nature of the

Repo 105 transactions or the trend that Lehman's net leverage ratio only temporarily fell just when it was time to issue public reports.

Lehman's auditor maintained that Repo 105 transactions were but one of numerous end-of-quarter transactions that investment banks do to make their balance sheets look better. The auditor maintained that there is nothing remarkable about Repo 105 and that an auditor's only role with respect thereto is to make sure the accounting is correct. If the accounting is correct, the auditor maintained, it does not matter if the transactions are being done as a means to manipulate net leverage. The auditor further asserted that Lehman engaged in substantial volumes of other off-balance sheet transactions that a reader of Lehman's financial statements would not know about, and that those transactions dwarfed the Repo 105 transactions.

Lehman's external auditor further stated that net leverage ratio is not a GAAP measure expected to be included in financial statements and that disclosures of Repo 105 activity were not required at the time of Lehman's financial reports. With respect to MD&A issues, the external auditor stated that it is not responsible unless (i) the numbers contained in the MD&A were inconsistent with the numbers in the financial statements; (ii) there is a material inconsistency between the MD&A and financial statements; or (iii) the auditor knew that information in the MD&A was materially misleading. The auditor asserted that none of those scenarios applied to the Lehman MD&A, and that the MD&A is the responsibility of management and disclosure counsel.

Whether the auditor correctly understood its responsibilities is for a trier of fact to decide, but a few points are abundantly clear: Ratings agencies and senior Lehman executives well understood the critical importance of Lehman's leverage to the investing public; the auditor did not qualify its opinion in any way or advise the Board of the end-of-period Repo 105 transactions; and the public traded millions of Lehman's shares without knowledge of the extent or purpose of Lehman's end-of-period Repo 105 transactions.

Lehman's Liquidity Pool

The inadequacy of Lehman's liquidity pool – the cash, government securities and other high-quality assets that Lehman set aside for its known funding needs – played a key role in Lehman's bankruptcy filing. Lehman represented in its regulatory filings and public disclosures that its liquidity pool was intended to cover expected cash outflows for 12 months in a stressed liquidity environment. Lehman reported that its liquidity pool contained $34 billion at the end of the first quarter of 2008, $45 billion at the end of the second quarter of 2008, and $42 billion at the end of the third quarter of 2008. In all cases, Lehman represented that its liquidity pool was unencumbered, meaning that it was composed of assets that could be "monetized at short notice in all market environments."

After Bear Stearns' near collapse in March 2008, regulators, lenders and the investing public all looked to Lehman's liquidity pool as a key indicator of Lehman's financial health. Though Lehman was well aware of this focus, it began to cut corners as clearing banks and overnight lenders sought increasing amounts of collateral. By the summer of 2008, Lehman began to count in its liquidity pool assets it had deposited or pledged to its clearing banks. In the days before Lehman's bankruptcy filing, encumbered assets that likely could not have been converted to cash quickly in a funding emergency comprised a significant portion of the pool.

Lehman never affirmatively advised its Board, the ratings agencies or the investing public of the billions of dollars of deposits and pledges that affected its liquidity pool. At the same time, Lehman did not attempt to hide from the regulators what it was doing. The SEC and the Fed each knew that significant amounts counted as liquidity were in fact posted as comfort deposits in order for Lehman to do business; the Fed knew that significant amounts counted as liquidity were in fact actually pledges to lenders. The agencies internally disagreed with Lehman's inclusion of these amounts as liquidity, yet took no action to require Lehman to adjust its public reporting of the numbers.

How could Lehman count deposits, pledged property and other encumbered assets in its liquidity pool? The fault lies, of course, with Lehman itself and to some extent with regulators for failing to regulate Lehman's practices, but it did not help that there was no consistent standard of what constitutes a liquid asset.

In the absence of a clear definition, Lehman and its regulators created their own. For example, Mr. Tonucci stated that an asset monetizable in five days was suitable for Lehman's liquidity pool, although Lehman did not always comply with this definition. Other Lehman managers said they were unaware of a five-day rule. The SEC applied a 24-hour test, meaning that to be considered liquid an asset had to be convertible to cash in one day; however, the SEC rarely questioned whether certain types of assets were appropriate for a liquidity pool. The Federal Reserve Bank of New York (FRBNY) had no set rule for determining what assets were appropriate for a liquidity pool; it evaluated pool assets on a case-by-case basis, noting that certain assets could be considered liquid if the clearing banks released their liens. When the FRBNY calculated the amount of Lehman's liquidity pool for its own purposes, the FRBNY *subtracted* assets pledged to Lehman's clearing banks from the total amount of the liquidity pool, even though Lehman continued to count these assets.

Lehman publicly discussed its liquidity pool because liquidity was essential to maintaining the confidence of Lehman's trading partners. On June 9, 2008 – just three months before declaring bankruptcy – Lehman announced its liquidity pool was, at $45 billion, its “largest ever.” That same month one of Lehman’s clearing banks, Citibank, required that Lehman post $2 billion as a “comfort deposit,” as a condition for Citi’s continued willingness to clear Lehman’s trades. Later in June, Lehman posted $5 billion of collateral to JPMorgan, Lehman’s main clearing bank, in response to an earlier demand by JPMorgan. Lehman continued to count virtually all of these deposits in its reported liquidity pool.

On September 10, 2008 – five days before it filed for bankruptcy – Lehman publicly announced that its liquidity pool was holding steady at approximately $41 billion. By Friday, September 12, however, Lehman actually had less than $2 billion of assets that could readily be turned into cash; it literally did not have sufficient cash to open for business on Monday, and it filed for bankruptcy protection on September 15. We now know that Lehman’s report of a $41 billion liquidity pool on September 10 was off by tens of billions of dollars.

Lehman’s auditor stated that it was highly involved in monitoring Lehman’s liquidity pool. But when I asked if the auditor was aware of or had concerns with Lehman’s inclusion of certain assets in the liquidity pool, the auditor stated that the *composition* of the liquidity pool was a matter for the regulators, not the auditor. Whether or not this description of responsibility is accurate, the bottom line is that the auditor apparently did not check whether Lehman’s liquidity pool was in the least bit liquid. And anyone who tried would have been faced with widely disparate definitions of liquidity. Clear standards are needed to ensure that someone other than the party in interest provides a check on whether liquidity pools are liquid and can actually serve their intended purpose.

Lessons Learned

Lehman’s auditors maintained that Repo 105 transactions were permissible under existing accounting rules and that existing accounting rules did not require any analysis of the content of liquidity pools. Whether they are right about what the rules did and did not require is a matter for litigation and is not for me to comment on. But I can say that if the existing rules did not require better disclosure, this Committee ought to consider filling that vacuum.

Lehman's collapse and misleading disclosures offer a tragic example of a silo mentality, with no one taking responsibility for the entire farm. The Fed and the Treasury were in a position to intervene but viewed the SEC as Lehman's primary regulator. Yet former SEC Chairman Cox told me that the SEC's jurisdiction was limited to Lehman's broker-dealer subsidiary, not Lehman itself. To be fair, Chairman Cox's successor, Mary Schapiro, took a different view and acknowledged that mistakes were made. But the point is that the consistent story I heard was that "it was not my job." It is important that someone be identified – with no ambiguity – and tasked with the job of taking responsibility for financial oversight.

Lehman's former Global Financial Controller Martin Kelly stated that he expressed his concern over Lehman's undisclosed Repo 105 activity to consecutive Lehman CFOs (Erin Callan and Ian Lowitt), and warned each of them of the "reputational risk" Lehman faced if its reliance on Repo 105 became known to the public. Yet Mr. Kelly contended that it was the job of more senior officers to limit or stop Lehman's Repo 105 activity. Lehman's outside disclosure counsel said he was never told of Lehman's Repo 105 activity, although some of the Lehman personnel he communicated with and relied upon knew about the Repo 105 transactions and their effect on net leverage.

Ms. Callan stated that it was the job of controllers and auditors to determine what came off the balance sheet at quarter-end. When she had to certify Lehman's financial statements, Ms. Callan said she relied upon sub-certification by Chris O'Meara, the previous CFO. When it came time for Mr. Lowitt to certify financial statements, he said he relied upon Ms. Callan's sub-certification. Richard Fuld, Lehman's former CEO, said that he relied upon Lehman's Chief Legal Officer and CFOs to inform him whether any information that should be in the financial statements was missing before he would certify them.

So to review the bidding, Lehman's senior executives weren't responsible because they relied on the auditors and other executives. The auditors weren't responsible because they relied on the executives and the lawyers. And the lawyers relied on the executives. But the public – who rely on the financial statements – who do they get to rely on?

Lehman's external auditor erected several of its own silos. Representatives of the auditor, including the lead auditor, stated the following:

- The auditor reviewed Lehman's Repo 105 accounting *policy*, but not Lehman's Repo 105 *practice*. The auditor reviewed Lehman's Repo 105 policy "on a theoretical level."

- The auditor was not required to look at either the volume or timing of Lehman's Repo 105 transactions at quarter end.

- The auditor does not have responsibility for the MD&A unless the numbers are inconsistent with the financial statements, there is a material inconsistency between the MD&A and the financial statements, or if the auditor actually knew that information in the MD&A was materially misleading. I understand this position to mean that, regardless of how apparent a materially misleading statement may be, an auditor has no responsibility for the MD&A if it has not actually put two and two together.

- If the accounting is technically correct, it does not matter to the auditor if the Repo 105 transactions were being done to manipulate net leverage. When I asked if technical adherence to an accounting rule could nevertheless lead to a material misstatement, the lead auditor stated, "You've got to ask an attorney."

- The auditor intended to perform additional tests regarding alleged balance sheet manipulation as part of the annual audit, and was not required to do so for the quarterly reviews.

I am not here to serve as judge and jury as to whether these interpretations of an auditor's duties are consistent with the professional standards. If they are, then this Committee should consider whether the standards need to be revised. But I can say that the end result was that Lehman's auditor did not question Lehman's nondisclosure of Repo 105 accounting transactions or consider whether these transactions were undertaken solely to dress up the balance sheet. Lehman's auditor never communicated anything about Repo 105 transactions to Lehman's Audit Committee members even though the Audit Committee instructed the auditor to investigate allegations regarding the balance sheet made by a whistleblower.

My Report cites rules that require financial statements to be fair, accurate, and not misleading, beyond including technically correct accounting. It is important to emphasize that in the world of financial reporting, the whole is supposed to be greater than the sum of the parts. If a mere recitation of numbers and technical accounting masks a trend (such as billions of dollars coming off and on the balance sheet at period end), the financial reports may not be fair and accurate. To the extent the existing rules are ambiguous, there should be rules that require the auditors, before they issue an unqualified report to accompany financial statements, to assure themselves that technical accounting procedures are not being used to manipulate material indicators like leverage. If the rules do not exist already, there should be rules that require the auditors, before they issue an unqualified report, to assure themselves that material issues like liquidity are accurately portrayed. If auditors are not already required to determine whether the specific assets held out to the public as liquid are in fact liquid, they should be. And to assist the auditors, a common, concrete definition of liquidity for accounting purposes is needed.

This is a subject deserving of careful study. Common sense dictates that fundamental concepts like "net leverage" and "liquidity" should not be a function of manipulation and subterfuge. We need to have clear and understandable rules if we are going to avoid these mistakes in the future.

Based on my experience from the Lehman investigation and several decades of civil and criminal litigation, and in addition to the points raised above, I offer the following suggestions for how auditors can help prevent the next financial crisis. I will defer to the accounting experts and this Committee whether existing rules need to be tightened in some of these areas or whether improvement lies in execution and enforcement.

1. *Do not marginalize the "whistleblower."* Auditors must take seriously and fully analyze allegations of financial impropriety. Auditors face intense pressures to conclude their analyses quickly in order to allow financial statements to be released on time but have an important responsibility to follow the facts wherever they may lead.
2. *Abandon the Quest for Immateriality.* When red flags arise, auditors must avoid the mindset of first and foremost finding a way to describe the issue as immaterial. Existing rules require analyses of *qualitative* materiality – particularly when management is trying to actively manage the financial statements – and not just number-crunching, to determine if an issue is material. These rules need to be tightened or enforced more aggressively.
3. *Management representations are one piece of evidence, not insurance policies for auditors.* External auditors cannot be expected to uncover every instance of fraud or other wrongdoing. But existing rules require auditors to assume neither that management is honest nor dishonest. Existing rules require auditors to approach their work with independence and professional skepticism and to rely on "competent" evidence rather than accepting whatever they may be told by a bad egg in management. Auditors are certainly entitled to place some reliance on management representations, but

as the engagement letter between Lehman and its auditor acknowledged, representations must be viewed as only one piece of evidence available to auditors. For example, Lehman's auditors could have, but did not, ask the relevant Lehman personnel the business purpose of the $50 billion of end-of-period Repo 105 transactions, and could have, but did not, examine any evidence of the volume, timing, and purpose of those transactions.

4. *The client is the Audit Committee.* Related to my prior observation, auditors must remember that their client is the company's Board of Directors and Audit Committee, not management. Auditors face immense pressure to be "team players" with senior management and not to rock the boat, but they must serve the Board as an independent check on management.

5. *The "review" process must have some teeth.* Auditors often emphasize the difference between a full audit of annual financial statements and more limited reviews of quarterly financial statements. Although it is not realistic or cost-effective to require full-blown audits every quarter, when red flags appear existing rules need to be tightened or enforced to ensure that an adequate analysis is performed even for quarterly filings.

6. *Existing rules must be tightened and enforced.* In some areas, the rules are not up to the task. For example, there are no clear rules for the measurement and reporting of the critical metric of liquidity; there should be. But one rule does exist that needs to be better enforced. Under existing rules, auditors are not permitted to stop at whether the individual pieces of a financial statement are in technical compliance with accounting principles – they must opine on whether the financial statements taken as a whole accurately and fairly portray the entity. In other words, the whole is greater than the sum

of its parts, and the public does rely on auditors to perform this critical function. A clean audit report should mean that the financial statements fairly portray the company. When auditors fail to identify or find ways to excuse material misstatements – whether by classifying errors and misstatements as immaterial, placing undue reliance on management representations, or providing other explanations to avoid rocking the boat – they fail in their fundamental role. Unless we enforce these existing rules and standards, it will be difficult to count on the auditors to help prevent another financial crisis.