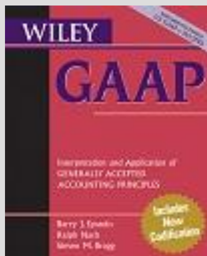
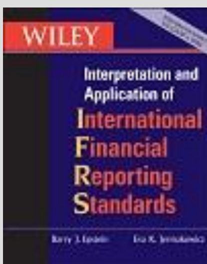
Russell Novak & Company LLP

Dr. Barry Epstein

Dr. Epstein is the author of **The Handbook of Accounting and Auditing**, published by RIA, the tax and accounting business of Thomson Reuters.





Dr. Epstein served as the lead author of **Wiley GAAP** and **Wiley IFRS** for 26 and 14 annual editions, respectively.

MF Global Off-Balance-Sheet Accounting:

It's Déjà vu All Over Again

by
Barry Jay Epstein, Ph.D., CPA, CFF
Russell Novak & Company, LLP
Chicago, Illinois

Revelations about MF Global's accounting for its "repo-to-maturity" financing arrangements in connection with Chairman and CEO Jon Corzine's $6.3 billion bet on European sovereign debt securities should sound very familiar to those who studied the Lehman "repo 105" and "repo 108" accounting deceptions. In the first leg of the latter instances, Lehman Bros. was able to regularly "window dress" its quarterly balance sheets by rationalizing that over-collateralized repurchase agreements (really secured borrowings) were effectively real sales of the securities only nominally sold (the collateral), and thus removed both those securities and the repurchase obligations from its balance sheets. In the second leg of the accounting fraud, Lehman used the borrowed funds to pay down other debt obligations, thereby dressing up its balance sheets to suggest enhanced debt-to-equity ratios, a key measure of its solvency. At minimum, this violated the clear spirit of financial reporting rules that have long held that repos do not connote actual sales of securities, but merely their use as collateral for borrowings.

In the MF Global case, based on what has been disclosed to date, management employed a similar – and similarly improper – deception, by using firm-owned securities (the aforementioned European debt instruments) to collateralize repos having maturity dates corresponding to the due dates on the underlying debt instruments. MF Global treated these repurchase arrangements, as did Lehman Bros. before it, as actual sales, thus masking its true financial position and making it at least possible to use the borrowed cash to further window dress its balance sheets.

The logic of that accounting treatment is no stronger than Lehman's argument that, since the counter-parties to its repos were over-secured, a default on the obligation to repurchase the securities would actually be a bonus to the lender and thus would not be

objected to, and hence the repo was tantamount to a real sale, even if in actual practice all the repo'ed securities were in fact repurchased as per the contractual obligations. Presumably MF Global argued successfully to its auditors that, since the maturities of the underlying collateral and the repos were matched, the proceeds from the maturing debts could be directed to the repo counter-parties, eliminating MF Global's "middleman" role, and thus making the original repo tantamount to an outright sale.

In both cases, the accounting was fatally flawed for two reasons, both of which should have been abundantly clear to the respective auditors.

MF Global Bankruptcy Reveals Two Accounting Flaws

First, it flies in the face of the spirit, if not the actual letter, of GAAP governing accounting for sales and transfers of financial assets, as set forth originally by FASB Statement No. 140, as amended (now codified as ASC 860). That provides that assets (such as MF Global's Euro bonds) can only be derecognized if control is surrendered and consideration other than beneficial interests in the transferred assets is received in exchange. Surrender of control is satisfied if and only if all of the following conditions are met:

> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
>
> b. The transferee has the right to pledge or exchange the assets it received, and no condition 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.
>
> c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

Clearly, the Lehman "repo 105" arrangements, albeit over-collateralized, failed condition (c) above, since Lehman was obligated under the repo to repurchase the assets, presumably before maturity. It must be inferred that the MF Global auditors (PricewaterhouseCoopers LLP) believed, and would argue, that since the repo closing trade was to occur on the underlying collateral's maturity date, condition (c) above was satisfied. (Not enough information is known to address whether conditions (a) and (b) were or were not met, for either the Lehman "repo 105" or MF Global "repo-to-maturity" arrangements.)

The same standard provides that liabilities may be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Given that both the Lehman and MF Global deals were structured as repurchase agreements, by definition those entities had not been released from being primary obligors.

Second, liabilities unlike assets cannot be reported at net realizable values. Financial assets such as accounts receivable and investments are reduced, for financial reporting purposes, from historical cost to a lower amount when circumstances suggest that amount will not be realized, as when allowances for uncollectible receivables or loans are provided. Liabilities, on

the other hand, are reported at contractual amounts, even if the debtor (the reporting entity) believes or hopes it might not be held to full account in a final settlement. Only if the counter-party has contractually waived its right to full (or partial) repayment is the liability to be reduced in carrying value.

MF Global Off-Balance Sheet Accounting Questions Auditor Role

In the Lehman case, due to the over-collateralization, Lehman presumed the counter-parties would not object to a default, and thus it was argued (successfully, apparently) to the auditors that the liability didn't really exist. In the MF Global situation, apparently, the auditors accepted the argument that since the payoffs at maturity would equal the amount owed to the counter-parties, there would be no net call upon the debtor's resources to settle the obligations. This ignores the fact that the legal obligation was MF Global's, and would have to be satisfied whether or not the underlying collateral's maturity value was received. Under GAAP, amounts due to and due from even the same counter-parties cannot generally be offset: clearly, amounts due to and due from *different* counter-parties cannot be netted. Yet, this is exactly what MF Global management did, with the auditors implied concurrence.

Philosopher-poet George Santayana said that "Those who cannot remember the past are condemned to repeat it." Alas, it appears so also are those that do.

About the Author: *Barry Jay Epstein, Ph.D., CPA, CFF (BEpstein@RNCO.com), is a partner of Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of* Wiley GAAP 2010*,* Wiley IFRS 2010*,* Wiley IFRS Policies and Procedures*, the WG&L* Handbook of Accounting and Auditing, *and other books.*