Ira W. Sohn Investment Research Conference
David Einhorn, Greenlight Capital, "Accounting Ingenuity"
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I appeared at this conference six years ago and joked that my wife, while trying to help me prepare my presentation of the Allied Capital analysis, had a hard time staying awake. This is pretty ironic, since the ensuing fallout from that speech has cost us a substantial amount of sleep. Over the past six years I have learned a lot and grown a little, and formed some strong views about Wall Street regulation and the muzzle it often places on free speech.

I think that research conferences like these are important. Of course, this one is particularly worthy because it supports a great cause: The Tomorrows Children's Fund. Further, it is important for investors to discuss market information and analysis to help sort the good companies from the bad. But, there is a structural impediment in our financial markets that creates a massive disincentive to share research about companies doing bad things.

I can fully understand why other investors might decline to appear in this forum or to share a critical analysis. Who could blame them? The cost is high (think lawyers here), it extracts an enormous personal toll, and there are better ways to raise money for a good charity. I have decided to persist because I believe it is important and the right thing to do.

Since the Allied speech, I have developed a thicker skin. Back then, when Allied COO Joan Sweeney said that my "plan was to scare the little old ladies," it actually bothered me. When Holman Jenkins at The Wall Street Journal equated my presentation to a "mugging" – a violent crime – I was incensed because it wasn't fair. Now, when I read book reviewers of *Fooling Some of the People All of the Time* calling me naïve because of how I used to believe the system worked, I'm just happy if they like the book.

The Allied experience gives me less confidence today than I had six years ago that the regulators are even trying to enforce rules to protect investors from dishonest public disclosures and outright lies by unscrupulous corporate managements. Maybe they are understaffed or too busy with other priorities. Maybe they are not as sophisticated or close enough to the issues. However, my experience leads me to fear that maybe they just don't care.

In *Fooling Some of the People All of the Time*, I point out that the SEC is not enforcing the existing anti-fraud rules against corporate managements. I wonder if part of the reason Bear Stearns lost the market's confidence was a sense that Bear had undisclosed losses and that the SEC was not taking proper measures to ensure that Bear reported accurate financials. The large losses that JP Morgan has now acknowledged on Bear's books support this theory. The lack of confidence in the SEC's oversight ultimately undermines investor confidence.

When I speak of investors I am including hedge fund managers. An author on Investopedia defined hedge funds as "lightly regulated, private investment funds that use unconventional investment strategies and tax shelters in an attempt to make extraordinary returns in any market…these factors have given them a secretive and shady aura in the financial community." Forbes has called us "The Sleaziest Show on Earth." Basically, according to some in the media, elected officials, government regulators and individuals, hedge funds are really gambling operations amounting to ticking time bombs with secret plans to destroy the galaxy. Good thing they don't say what they really think. In truth, hedge fund managers at their core are simply investors.

The SEC seems much more interested in whether investors share analysis, particularly critical analysis, of public filings rather than whether management teams made accurate public filings in the first place. The SEC seems more interested in whether investors discuss investments among themselves on private phone calls than in whether management teams make truthful statements on public conference calls. The SEC seems more likely to bring a case against an individual investor over a small crime than it is to prosecute a large corporation that fudges its numbers for years on end and pays out management bonuses in the millions based upon inflated accomplishments.

Imagine what would happen if a whistle-blower made a detailed public presentation showing a hedge fund cooked its books. Under no circumstance would the immediate focus start by investigating the accuser. How long would it take for the SEC to arrive and how tirelessly would the media investigate and cover the story? What would the chance be that the SEC would take five years to find exactly the type of record keeping violations that were alleged in the first instance and, then, inflict no meaningful penalty on the offender? How likely is it that the SEC would permit additional sales of equity in that hedge fund to new investors? How likely is it that our most prestigious investment banks would line-up to introduce that hedge fund to new capital?

Imagine if a hedge fund operated a unit that defrauded the SBA federal lending program out of millions of dollars – engaging in what the SBA inspector general would call "the largest fraud in SBA history." How long would that hedge fund be in business?

Imagine if a hedge fund hired a private investigator to impersonate the spouse of a CEO and obtained his home and business telephone records. Imagine if after making loud, public denials, the hedge fund admitted to obtaining the records, but did not explain or apologize, or even return the stolen records, when requested. How long would it be before someone was arrested?

Of course, I don't know of a hedge fund that has done these things. Everybody now knows that Allied Capital has. The Allied situation persists only because of lax regulatory enforcement and Wall Street's continued willingness to sell new shares to unsophisticated retail customers.

The double standard is evident. And Allied Capital is a primary example. Three years before my speech, Allied Capital's CEO, Bill Walton, made the following statement in a magazine interview:

> Open and consistent accounting starts with an attitude of zero tolerance for improprieties. People need to see that people are rewarded for candor in reporting and punished for slipshod practices. The CEO really has to set the moral tone. Without that, nothing happens.
>
> There's enormous pressure on public companies to maintain quarterly earnings momentum, and it's probably growing worse. The bigger thing that firms get punished for are surprises, particularly negative ones. It's better to face up to bad facts and reporting the business as it is, rather than trying to hide things and make it far worse later on.
>
> If you develop a reputation for candor with securities analysts and investors, that's about the best you can do. At the end of the day, investors understand that building a business is not an uninterrupted, smooth road. First, you have to determine whether it's a systematic problem or a people problem. **If there's a dishonest person involved, you get rid of the person.**

If Mr. Walton is correct, why is he still employed…and making tens of millions?

I want to go outside the usual format for this event and ask this audience by applause… who agrees with me that there should be some significant consequence to the folks at Allied for what they have done?

One of the key issues I raised about Allied six years ago was its improper use of fair value accounting, as it had been unwilling to take write-downs on investments that failed in the last recession. That issue has returned on a much larger scale in the current credit crisis.

Recently, we had the CEO of a financial institution in our office. His firm held some mortgage bonds on its books at cost. The CEO gave me the usual story: The bonds are still rated AAA, they don't believe that they will have any permanent loss, and there is no liquid market to value these bonds.

I responded, "Liar! Liar! Pants on Fire!" and proceeded to say that there was a liquid market for these bonds and they were probably worth 60-70% of face value at the time, and that only time will tell whether there will be a permanent loss.

He surprised me by saying that I was right. He observed that if he said otherwise, the accountants would make them write the bonds down.

The issue of the proper use of fair value accounting isn't about strict versus permissive accounting. The issue is that some entities have made investments that they believed would generate smooth returns. Some of these entities, like Allied, promised investors smoother earnings than the investments could deliver. The cycle has exposed the investments to be more volatile and in many cases less valuable than they thought.

The decline in current market values has forced these institutions to make a tough decision. Do they follow the rules, take the write-downs and suffer the consequences whatever they may be? Or worse, do they take the view that they can't really value the investments in order to avoid writing them down? Or, even worse, do they claim to follow the accounting rules, but simply lie about the values?

The turn of the cycle has created some tough choices. Warren Buffett has said, "You don't know who is swimming naked until the tide goes out."

I do not believe the accounting is the problem. The creation of FAS 157 and other fair value measures has improved disclosure, including the disclosure of Level 3 assets – those valued based upon non-observable – and in many cases subjective – inputs. This has helped investors better understand the financial positions of many companies.

For entities that are not over-levered and have not promised smoother results than they can deliver, when the assets have fallen in market value, they can take the pain and mark them down. It doesn't force them to sell in a "fire-sale." If the market proves to have been wrong, the loss can be reversed when market values improve. For levered players, the effect of reducing values to actual market levels is that the pain is more extreme and the incentive to fudge is greater.

With this in mind, I'd like to review Lehman Brothers' last quarter. Presently, Greenlight is short Lehman. Lehman was due to report its quarter two days after JP Morgan and the Fed bailed out Bear Stearns. At the time, there were a lot of concerns about Lehman, as demonstrated by its almost 20% stock price decline the previous day with more than 40% of its shares changing hands. In the quarter, bond risk spreads had widened considerably and equity values had fallen sharply. Lehman held a large and very levered portfolio.

With that as the background, Lehman announced a $489 million profit in the quarter. On the conference call that day, Lehman CFO Erin Callan used the word "great" 14 times, "challenging" 6 times; "strong" 24 times, and "tough" once. She used the word "incredibly" 8 times. I would use "incredible" in a different way to describe the report. The Wall Street Journal reported that she received high fives on the Lehman trading floor when she finished her presentation.

Twenty-two days after the conference call, Lehman filed its 10-Q for the quarter. In the intervening time, I had made a speech at the Grant's Spring Investment Conference where I observed that Lehman did not seem to have large exposure to CDOs. This was true inasmuch as Lehman had not disclosed significant CDO exposure.

Let's look at the Lehman earnings press release (Table 1). Focus on the line "other asset backed-securities." You can see from the table that Lehman took a $200 million gross write-down and has $6.5 billion of exposure.

Table 1 - Lehman's 1Q08 Press Release

In billions	Mark to market Adjustments Gross	Net	Gross Balances as of 29-Feb-08	30-Nov-07
Residential mortgages:				
Securities			18.2	16.7
Whole loans			11.9	14.2
Servicing and other			1.7	1.2
Total Residential	(3.0)	(0.8)	31.8	32.1
Other ABS (non-residential)	**(0.2)**	**(0.1)**	**6.5**	**6.2**
Commercial mortgages:				
Whole loans			24.9	26.2
Securities and other			11.2	12.7
Total Commercial	(1.1)	(0.7)	36.1	38.9
Total Mortgages & ABS			74.4	77.2

Lehman Press Release March 18, 2008, page 13

Now let's look at page 56 of the 10-Q (Table 2). See that same exposure of $6.5 billion.

Table 2 - Lehman's 10-Q

In billions	29-Feb-08	30-Nov-07
Residential mortgages:		
Securities	18.2	16.7
Whole loans	11.9	14.2
Servicing and other	1.7	1.2
	31.8	32.1
Commercial mortgages:		
Whole loans	24.9	26.2
Securities and other	11.2	12.7
	36.1	38.9
Other asset-backed securities (1)	**6.5**	**6.2**
Total (2)	74.4	77.2

Lehman February 2008 Form 10-Q, page 56

Now let's look at the footnote 1 of the table, explaining *Other asset-backed securities*:

> The Company purchases interests in and enters into derivatives with collateralized debt obligation securitization entities ("**CDOs**"). The CDOs to which the Company has exposure are primarily structured and underwritten by third parties. The collateralized asset or lending obligations held by the CDOs are generally related to franchise lending, small business finance lending, or consumer lending. **Approximately 25% of the positions held at February 29, 2008 and November 30, 2007 were rated BB+ or lower (or equivalent ratings) by recognized credit rating agencies…** [emphasis added]

Last week, Lehman's CFO and corporate controller confirmed that the whole $6.5 billion consisted of CDOs or synthetic CDOs. Ms. Callan also confirmed that the 10-Q presentation was the first time that Lehman had disclosed the existence of this CDO exposure. This is after Wall Street spent the last half year asking, "Who has CDOs?" Incidentally, I haven't seen any Wall Street analysts or the media discuss this new disclosure.

I asked them how they could justify only a $200 million write-down on any $6.5 billion pool of CDOs that included $1.6 billion of below investment grade pieces. Even though there are no residential mortgages in these CDOs, market prices of comparable structured products fell much further in the quarter. Ms. Callan said she understood my point and would have to get back to me. In a follow-up e-mail, Ms. Callan declined to provide an explanation for the modest write-down and instead stated that based on current price action, Lehman "would expect to recognize further losses" in the second quarter. Why wasn't there a bigger mark in the first quarter?

Now, I'd like to put up Lehman's table of Level 3 assets (Table 3). I want you to look at the column to the far right while I read to you what Ms. Callan said about this during the Q&A on the earnings conference call on March 17.

> [A]t the end of the year, we were about 38.8 [billion] in total Level 3 assets. In terms of what happened in Level 3 asset changes this quarter, we had net sort of payments, purchases, or sales of 1.8 billion. We had net transfers in of 1.1 billion. So stuff that was really moved in or recharacterized from Level 2. And then there was about 875 million of write-downs. So that gives you a balance of 38,682 as of February 29.

As you can see, the table in the 10-Q does not match the conference call. There is no reasonable explanation as to how the numbers could move like this between the conference call and the 10-Q. The values should be the same. If there was an accounting error, I don't see how Lehman avoided filing an 8-K announcing the mistake. Notably, the 10-Q changes somehow did not affect the income statement, as there must have been other offsetting adjustments somewhere in the financials.

Table 3 - Level 3 Asset Movements in 1Q

In billions	Mortgage & ABS	Corp Debt & Other	Corporate Equities	Derivatives	Total
4Q 2007 Balance	**24,952**	**3,082**	**8,373**	**2,477**	**38,884**
Net Payments, Purchases, Sales	46	524	360	73	**1,003**
Net Transfers In/(Out)	(519)	655	(80)	34	**90**
Gains/(Losses):					
Realized	83	24	27	(20)	**114**
Unrealized	(750)	(35)	695	204	**114**
Total Gains / (Losses)	**(667)**	**(11)**	**722**	**184**	**228**
1Q 2008 Balance	**23,812**	**4,250**	**9,375**	**2,768**	**40,205**

Lehman February 2008 Form 10-Q, page 25

When I asked them about this, Lehman said that between the conference call and the 10-Q they did a detailed analysis and found, “the facts were a little different.”

I want to concentrate on the $228 million of realized and unrealized gains Lehman recognized in the quarter on its Level 3 assets. There is a $1.1 billion discrepancy between what Ms. Callan said on the conference call – an $875 million loss – and the table in the 10-Q, which shows a $228 million gain.

I asked Lehman, “My point blank question is: Did you write-up the Level 3 assets by over a billion dollars sometime between the press release and the filing of the 10-Q?” They responded, “No, absolutely not!”

However, they could not provide another plausible explanation. Instead, they said they would review the piece of paper Ms. Callan used on the call and compare it to the 10-Q and get back to me. In a follow-up e-mail, Lehman offers that the movement between the conference call and the 10-Q is “typical” and the change reflects “re-categorization of certain assets between Level 2 and Level 3.” I don’t understand how such transfers could have created over a $1.1 billion swing in gains and losses.

Others have asked Lehman about the large write-up in Level 3 corporate equities. It is hard to imagine, without a clear explanation, how an $8.4 billion portfolio gained $722 million during a period when the S&P fell 10%. This is particularly odd since about one-quarter of this bucket is Archstone-Smith, a multi-family REIT that Lehman says it wrote-down by a sizable, but undisclosed, amount.

Lehman had told others that it booked a large gain as a result of a pre-IPO financing round that was completed on a power company investment in Asia. The company in question was KSK Energy Ventures Limited, a power development company that operates three small power plants. According to Lehman, it booked a $400-$600 million unrealized gain on the investment in the first quarter.

Ms. Callan told me that during the first quarter "a new party" came in and completed a pre-IPO round in February at a much higher valuation than Lehman paid. She said Lehman valued the stake at a 30% discount to where the new party came in to reflect the restricted securities Lehman held.

KSK Energy Ventures filed a draft red herring prospectus in India on February 12, 2008 that revealed a different set of facts. Lehman had made an initial $112 million investment in KSK Electricity Financing in November 2005. The company completed a restructuring on January 20, 2008, through which Lehman sold its original investment for a gain of about $65 million and concurrently purchased about one-third of KSK Energy Ventures for $86.5 million. The only other significant shareholder, KSK Energy Limited, owns 65% of the remaining equity and did not contribute capital during this round.

I confronted them with the evidence that there was no subsequent round and that Lehman was the lead, if not the only, investor in the January restructuring. Suddenly, the story changed.

Management responded that it was "not sure" if Lehman was the lead on the round. It took what it "thought was the most conservative approach at the time and the low end of what all those data points produced." Management followed-up in an e-mail stating that in February it had "revalued" its January investment based on a variety of analyses including an <u>expected</u> pre-IPO round, a DCF analysis, forward EBITDA multiples, comparable companies and a third-party research report.

One of my partners remarked, "This seems like one helluva power plug!"

Additionally, during the quarter Lehman marked down its non-Level 3 mortgage assets by an average of 7%. You can see on the table that it marked down the Level 3 mortgages by $750 million, or only 3%. Though Lehman says that about 20% of the Level 3 mortgage assets are in markets that did better, such as Asia, they also contain many of the lowest quality assets including below investment grade residual interests, investment grade and below investment grade MBS and all of the subprime exposure.

In the real world, illiquid assets carry a discount. In the current melee the opposite seems true: illiquid assets are more valuable because it is easier to convince the accountants that they have not declined in value compared to liquid assets where there is more transparent pricing data.

Lehman had $39 billion of exposure to commercial mortgages at the end of the year. The index of AAA CMBS declined about 10% in the quarter. Lower rated bonds fell even further. Since Lehman's portfolio is less than AAA, it would seem its write-down probably should have been more than 10 points. Lehman wrote its exposure down less than 3 points gross.

Part of the commercial mortgage exposure is a venture called SunCal, where Lehman is a lender and equity investor. SunCal is a large land developer, principally in California's Inland Empire. This is one of the hardest hit housing markets in the country. A number of publicly-traded home builders have written land holdings in this area down to pennies on the dollar. Lehman has not disclosed a material charge on its SunCal investment.

Recently, Lehman analysts have been cutting second quarter estimates due to "hedge ineffectiveness." According to Lehman, hedges that mitigated the gross losses previously are now reversing faster than the assets Lehman owns. It seems to me that the hedge ineffectiveness might reflect Lehman more aggressively recognizing the gains on its hedges than the losses on its assets in prior periods.

At the Grant's Conference, before Lehman filed its 10-Q, I argued that if you assumed Lehman's balance sheet was accurate, it needed to de-lever and raise capital. Now, I believe the need is much greater.

My hope is that Mr. Cox and Mr. Bernanke and Mr. Paulson will pay heed to the risks to the financial system that Lehman is creating and that they will guide Lehman toward a recapitalization and recognition of its losses – hopefully before federal taxpayer assistance is required.

For the last several weeks, Lehman has been complaining about short-sellers. Academic research and our experience indicate that when management teams do that, it is a sign that management is attempting to distract investors from serious problems.

I think that there is enough evidence to show how Lehman answered the difficult question as to whether to tell the truth and suffer the consequences or not. This raises the question, though, of what incentive do corporate managers have to fully acknowledge bad news in a truthful fashion?

For the capital markets to function, companies need to provide investors with accurate information rather than whatever numbers add up to a smooth return. If there is no penalty for misbehavior – and, in fact, such behavior is rewarded with flattering stories in the mainstream press about how to handle a crisis – we will all bear the negative consequences over time. At a minimum, what message does this send to some of Lehman's competitors that probably didn't have problems quite as acute as Lehman, but who took sizable write-downs, and diluted their shareholders with significant equity raises?

Now, given my experience with Allied and the SEC, I have no expectation that Lehman will be sanctioned in any material way for what we believe it has done. I suspect that some of the authorities applaud Lehman's accounting ingenuity.