Walkthrough Template

Entity	Lehman Brothers Holdings, Inc.	Workpaper Ref.	**B3.Memo**
Subsidiary or Division	Fixed Income Derivatives – LBSF (Entity '0059')	Prepared by	Julie Whisenhunt Nahom Kidanemariam
Financial Statement Date	11/30/08	Reviewed by	Stefanie L. Weed

High Grade and High Yield Credit Default Swap Process:

Trade Entry/Trade Capture Process
Settlement Process
Confirmation Process
Collateral Management Process
P&L/Flash to GL Process
Valuation Process

Significant Class of Transactions/Process name: _____

This template assists in our documentation of walkthroughs under S04

Perform Walkthroughs of the *EY Global Audit Methodology* (*EY GAM*).

S03 Understand Flows of Transactions, WCGWs, and Controls of *EY GAM* requires us to gain an understanding of the flow of transactions within significant processes and the sources and preparation of information in sufficient detail for the purpose of:

- Identifying the types of errors that have the potential to materially affect relevant financial statement assertions related to significant accounts and disclosures
- When appropriate, identifying controls that are effective and sufficiently sensitive to prevent or detect and correct material misstatements in the related relevant financial statement assertion

S04 Perform Walkthroughs of *EY GAM* requires that we perform a walkthrough for each significant class of transactions within significant processes, including the sub-processes of the Financial Statement Close Process ("FSCP") and sources and preparation of information resulting in significant disclosures. The nature and extent of our walkthrough procedures will vary depending on our strategy relating to reliance on controls and the complexity of the process.

We obtain an understanding of and document the significant flows of transactions and sources and preparation of information prior to completing our walkthrough procedures. This documentation may exist in our current year or permanent files and is typically carried forward from year to year and updated as appropriate. If the client has sufficient documentation of the flow of transactions

or sources and preparation of information, we examine and, as appropriate, retain copies of the client's documentation in our current year or permanent files rather than preparing our own documentation.

For all audits regardless of our strategy (Controls Strategy or Substantive Strategy), we perform walkthroughs to achieve the following objectives:

- Confirm our understanding, as identified in our process documentation, of the flow of significant classes of transactions within significant processes or sources and preparation of information resulting in significant disclosures, including how these transactions are initiated, authorized, recorded, processed and reported: and
- Verify that we have identified the appropriate "what could go wrongs" (WCGWs) that have the potential to materially affect relevant financial statement assertions related to significant accounts and disclosures within each significant class of transactions.

Additionally, when we plan to assess control risk below maximum (Controls Strategy), or for significant risks or risks for which substantive procedures alone do not provide sufficient evidence, we perform walkthroughs to achieve each of the objectives noted above, as well as the following objective with respect to the design and implementation of controls:

- Confirm our understanding of:
    - The accuracy of information we have obtained about identified controls over the flow of significant classes of transactions,
    - Whether the controls are effectively designed to prevent, or detect and correct material misstatements on a timely basis, and
    - Whether the controls have been placed into operation.

When performing our walkthrough procedures we focus on the critical path in the process where transactions are initiated, authorized, recorded, processed and ultimately reported in the general ledger (or serve as the basis for disclosures). In particular, we focus attention on the points where data is, or should be captured, transferred, or modified as these are the points where misstatements might be most likely to occur. Our walkthrough includes both the manual and automated steps of the process and we use the same source documents and information technology that client personnel typically would use. When the client's IT environment is complex, we work with TSRS (IT professionals) to the extent necessary to walk through the automated aspects of the flow of transactions or sources and preparation of information and if applicable, related controls.

This template assists in our documentation of walkthroughs and its use is highly encouraged. It is divided into three sections.

Section 1: Walkthrough Procedures

Section 2: Other Matters—Segregation of Incompatible Duties and Management Override of Controls

Section 3: Conclusion

Section 1: Walkthrough Procedures

Performance Guidance

S04_Perform Walkthroughs of *EY GAM* provides detailed guidance on performing walkthroughs. Teams may find S04_Exhibit 1 Perform Walkthroughs of *EY GAM* particularly helpful when executing our walkthrough procedures.

When we have decided to use the Substantive Strategy (i.e., assess control risk at the maximum), we limit our walkthrough to the relevant processing procedures needed to confirm our understanding of the flow of transactions or the sources and preparation of information resulting in significant disclosures.

For each walkthrough, we are required to document the following items:

- The transaction selected for walkthrough (Substantive and Controls Strategy);
- Individual(s) with whom we confirmed our understanding (Substantive and Controls Strategy);
- Description of the walkthrough procedures performed (Substantive and Controls Strategy); and
- Description of the walkthrough procedures performed to confirm our understanding of the design of the manual, IT-dependent manual and application controls on which we plan to test and rely upon and that such controls have been placed into operation (Controls Strategy only).

Documentation of Walkthrough Procedures Performed

Transaction selected for walkthrough (Substantive and Controls Strategy):	TradeID 20227926, Trade Date 5/2/2008, Notional Amount $250,000,000
Individual(s) we talked with to confirm our understanding (Substantive and Controls Strategy):	Trade Entry/Trade Capture: Peter Jenkins Confirmations: Andrew Kayiira, Settlements: Joe Dickinson, Patricia Nist, Estimate to Actual/Daily P&L: Nina Chand, Qwasi Garner Valuation: Scott Goswami, Suparna Ray, Todd Brooks[SLW1]

Confirming our Understanding of the Flows of Significant Transactions (Substantive and Controls Strategy)

Describe the walkthrough procedures performed, addressing the points at which the transactions are initiated, authorized, recorded, processed, and ultimately reported in the general ledger (or serve as the basis for disclosures), including both the manual and automated steps of the process. For sources and preparation of information resulting in significant disclosures, describe the procedures performed to confirm our understanding of the process and sources of information management uses to generate significant disclosures. We document whether processing procedures are performed as originally understood and in a timely manner.

While performing the walkthrough, we ask probing questions about the client's processes and procedures and related controls to gain a sufficient understanding to be able to identify important points at which a necessary control is missing or not designed effectively. For example, our follow-up inquiries might include asking personnel what they do when they encounter errors, the types of errors they have encountered, what happened as a result of finding errors, and how the errors were resolved. We might also question client personnel as to whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened. Our inquiries also should include follow-up questions that could help identify the abuse or override of controls, or indicators of fraud.

For purposes of the High Yield/High Grade Bonds memo we have included the following information:

I. General Background
II. Product Description
III. Information Technology Used
IV. Trade Entry/Trade Capture
V. Confirmations
VI. Collateral Management
VII. Settlements
VIII. Estimate vs. Actual (PC Cash Reconciliation)
IX. Credit Approval/Credit Risk
X. Daily P&L/Flash to GL Reconciliation
XI. Valuation (Price Verification)
XII. Valuation Adjustments

I. General Background

The majority of Lehman's credit default swaps are booked in Lehman Brothers Special Financing ("LBSF"), which is Lehman's fixed income derivatives dealer. However, some of the older trades are booked in Lehman Brothers International Europe ("LBIE"), which is London's Broker Dealer. Lehman Brothers has since changed most of the trades to flow through LBSF instead of LBIE through novations. For an overview of Lehman's Global Credit business, including organizational structure as well as CFO roles and responsibilities, see **B3.2 Credit Organizational Chart.**

The most common types of credit products are Credit Default Swaps (CDS), Credit Default Swaption, Index Default Swaps and Fixed Recovery Swaps. The majority of the derivatives transactions executed by the HYC group are CDS and Credit Default Swaptions transactions.

This memo will address Lehman's business as it relates to both High Yield and High Grade credit default swaps. High yield and high grade credit default swaps are inherently different products and as such, are viewed and price verified separately by Lehman. However, from a trade cycle perspective (in terms of the system flow in which they are processed through from inception of trade to settlement and the related key controls), there are no differences noted between the two products. Hence our walkthrough of a High Grade Credit Default Swap transaction (see **B3.1** for HG CDS population and for the selected trade) provides us with sufficient walkthrough coverage for both products.

II. Product Description

A **credit default swap** is a form of insurance where a counterparty can purchase protection (in the form of a premium) against the default of a certain issuer. The protection buyer will pay a

periodic insurance premium until maturity or a predefined credit event, whichever comes first. In some instances there are only upfront premiums.

For example, Counterparty A holds a fixed income security. To protect themselves against any defaults Counterparty A enters into a credit default swap with LBSF. In this trade, Counterparty A will pay an upfront premium or a series of premium payments to LBSF. In return LBSF acts as the seller of protection where LBSF is guaranteeing the credit worthiness of Counterparty A's fixed income security. By entering into this contract the risk of default is transferred from the holder of the fixed income security (Counterparty A) to the seller of the swap (LBSF).

There are three levels of protection that credit default swaps offer:

1. ***Senior***

This is the highest level of protection, and therefore the most expensive. Defaults are triggered the most easily with this type of insurance.

2. ***Modified Recovery (ModRe)***

This is the most common level of protection. Recovery occurs through a significant default or restructuring.

3. ***No Recovery (NoRe)***

This is the lowest level of protection. Recovery requires a full-blown default.

Each default swap has two legs:

- *Protection* – This leg of the trade is booked in SmartTicket and is straight-through processed ("STP") into the global deal-capture and valuation system that holds all default swaps called the Credit Derivative System, (CDS). It is the credit contingent leg, which computes the value of the insurance (the Mark to Market of the trade).
- *Premium* – This is the cash flow leg of the trade that is sent via STP from SmartTicket into CDS.

See flowchart at **B3 Flowchart 2 – HYC Derivatives Trade Diagram** for an example of a CDS trade and a basket of CDS trades.

III. Information Technology Used

Dynamix – System used for Credit default swaptions. Starting next year, the Credit Default Swapation will be migrated over to the dynamic valuation system [SLW2]

Smart Ticket – Derivatives trade entry/trade capture system and is used by Lehman's front office system to directly record the trade. Smart Ticket feeds Dream as well as CDS.

CDS – "Credit Derivatives System" houses all credit default swap valuations. CDS replaced SUMMIT in 2005 to assist in the settlement of all vanilla CDS trades. Smart Ticket feeds CDS which feeds MTM information to DMS. Caruso is another name for the CDS application.

DREAM – Derivatives confirmation system used to generate, track and age outstanding confirms.

SUMMIT – FID Derivatives valuation system for vanilla trades and feeds the MTM information of trades to DMS. Further, Summit feeds trade data to ASAP for payments.

eClerx – an India-based provider which performs pre-settlement confirmation, settlement and reconciliation services for Lehman Brothers.

DMS – centralized deal depository system (known as the "MTM warehouse" for derivatives).

CAMEO – "Collateral and Margin Exposure Optimization" system which calculates margin and exposure for derivative products and receives trade information from DMS.

PALS – Fixed Income Derivative P&L system

Quest – Lehman firm wide P&L system

DBS – General Ledger

ASAP – Automated Settlement and Payment System for Fixed Income and Equity Derivatives. It is fed by CDS (or by SUMMIT).

eSAP – a web-based version of ASAP used by some counterparties to verify their own payment information.

ITS – "International Trading System" that contains the books and records of all products. ITS reflects the cash movement and settlement that occurred via ASAP.

TWS – Treasury Work Station

GCCM – Global Cash Collateral Management system which facilitates the credit default swap settlements process.

SWIFT – Payment dispatch system.

GSSR – Global Smart Stream Reconciliation is the application used for bank reconcilations.

TLM – This is an outside service provider that performs multiple reconciliations for Lehman, such as reconciliations between CDS and DTCC Warehouse

See **B3 Flowchart 1 – CDS System Flowchart** in GAMx for the flowchart demonstrating the system flow.

Note: Key controls are identified in **bold**. Refer to work for further data on controls.

IV. Trade Entry/Trade Capture

Initiation and Authorization of Trades:

EY auditor selected the following high grade deal for our walkthrough to gain an understanding the credit deratives process. The trade selected for our walkthrough was booked in entity, LBSF ('0059'), and the details are as follows: :

Deal ID: 20227926
Counterparty: National Australia Bank Ltd
Trade Date: May 2, 2008
Effective Date: March 21, 2008
Maturity Date: June 20, 2013

EY auditors met with Peter Jenkins from Middle Office to discuss and observe the trade entry/trade capture process for the aforementioned trade.

The trade selected for our walkthrough was originally initiated on May 2, 2008 with the protection seller being Lehman Brothers (LBSF) and the protection buyer being National Australia Bank Ltd for an amount of $25m and a premium of 155 bps. The trade went through an assignment on May 8, 2008 where National Australia Bank assigned the credit default swap to Merrill Lynch International for the same notional amount. Thus, on May 8th, Lehman was still the protection seller but the protection buyer changed from National Australia Bank to Merryl Lynch.

First, a trader will enter into a new High Grade or High Yield Credit Default Swap transaction and records the trade into FID Blotter (**B3.A1a**). Not all traders use FID Blotter but in the case of our walkthrough sample the HG CDS was manually entered into the FID Blotter spreadsheet. FID Blotter does not feed any systems, and is used for traders tracking purposes.

Next, the trader will enter the trade directly into Lehman's front office system Smart Ticket **(B3.A2 and B3.A2a), Smart Ticket has built-in controls to ensure that all key information (i.e. credit approval) is entered in before it accepts the transaction.** Trade details are populated on the following sections on the Smart Ticket: 1) Deal Form – general deal information, 2) Default Leg – legal terms, 3) Swap Leg – deal economics, 4) Security Description – reference security details.

EY auditor obtained two Smart Ticket screens as the first trade was executed on May 2, 2008 (**B3.A2**) with National Austrialia Bank and the assigned trade occurred on May 8th, 2008 (**B3.A2a**) with Merrill Lynch. Once the trade information is entered, the trader will review it and electronically authorize the deal ticket to the Front Office Queue (see **B3.A2 1/** and

B3.A2a 1/ for the authorization status).**All new trade tickets and change forms must be authorized by trader to be processes into CDS**

Trades then get sent to Middle Office ("M/O") queue of Smart Ticket. M/O personnel performs a detailed review of all the trade economics (i.e. notional, fixed rate, payment dates, effective date and maturity date) and notifies the trader to make corrections if there is a discrepency.MO also assigns a book ledger to each individual trade. **After the transaction is reviewed and accepted and allocated to the respective ledgers, it is then sent via straight-through processing (STP) from Smart Ticket to the Credit Derivatives System ("CDS").**

There is a real time monitoring system in Smart Ticket which will show any trades that are pending and waiting to be STP to CDS. Any trades that are pending for more than two minutes are resolved by the IT desk (B3.A3).

CDS creates a template with the risk ID assigned to the trade and sends it back to the M/O. M/O Personnel then saves this ID into Smart Ticket. There is a Smart Ticket screen that shows all the trades that are pending STP to CDS for more than 2 minutes (**B3.A5**). Trades that take unusually long to STP to CDS are due to IT related issues and will be resolved by the IT desk.

Front Office to CDS Reconciliations

Through EClerx, an outside reconciliation provider, MO obtains daily files containing the reconciliations between Trade Blotter, SmartTicket, and CDS. MO reviews the reconciliations and resolves any breaks timely. CDS and Trade Blotters are reconciled (**B3.A12**). EClerx also performs a reconciliation between CDS and SmartTicket (**B3.A7**) and a broker reconciliation between the end of the day broker reports and SmartTicket (**B3.A13**). See **B3.12a**, **B3.A7a**, and **B3.A13a** respectively for clearance of breaks. These are daily reports, Middle Office reviews the reconciliations and resolves any breaks timely. Per conversation with Kan Cheng, all de-escalations are reviewed by the immediate manager of the analysts responsible for the breaking item. Typically breaks appearing on the CDS to Trade Blotters and SmartTicket to broker reports are investigated and cleared the same day the report is released. The eClerks CDS to Smart Ticket reconciliation is reviewed weekly, therefore, the report should not have aged breaks past four to seven days. Two additional reconciliation reports performed by eClerks are the Intercompany Report **(B3.A14)** and the Intracompany Report **(B3.A15).** The Intercompany Report reveals breaks between different entities due to differences with mirroring, while the Intracompany Report shows breaks occurring within one entity due to such differences as valuation, curves, and timing. All eClerks reports are automated daily[JW3].

Change Forms/Deal Terminations

Modifications (i.e., Smart ticket change forms) are not straight through processed into the Middle Office Systems. CDS payments are fed directly from CDS to ASAP. Once the trader has authorized a trade to Middle Office, no changes can be made to the deal in Smart Ticket. This control is in place to ensure that all systems and documentation are in agreement. If it is

determined that certain aspects of a deal need to be changed, the individual from M/O or B/O who identified the change would generate a change form in Smart Ticket and submit it for trader's approval. The trader must approve all changes. Change forms do not have STP capabilities and necessary adjustments have to be made manually in CDS. Lehman is working on being able to execute the change forms via STP, but there is no time frame set. Deal terminations are handled in the same way as change forms.

V. Confirmation

The confirmation process is a cross-product process and as such is being walkthrough separately on its own. Please refer to the Confirmation memo and walkthrough in GAMx at **B11**.

VI. Collateral Management

Margin on Collateral is monitored and posted. Trade information from DMS is fed to the margin system (CAMEO). For details on the Collateral Management process and associated controls surrounding the process, please refer to the Collateral Management memo and walkthrough in GAMx at **B12**, as this is a cross-product process.

VII. Settlements

E&Y auditors met with Joe Dickinson and Patricia Nist of Operations to discuss the settlement process for High Yield and High Grade Credit Derivatives. Joe's group is responsible for the global (London, New York, and Tokyo) daily settlement of fixed income derivatives across all entities (LBSF, LBFP, LBDP and LBIE). The settlement process for all fixed income derivatives is the same**.** Middle Office uploads payment information (such as rates, reset date, notional amount, maturity date) from Smart Ticket into CDS.

CDS is used primarily for consolidating derivative positions (risk management) and for valuation. Positions are valued in CDS at 7pm daily. CDS is used for settlement purposes for all vanilla CDS trades. Settlement instructions and payment schedules are fed automatically from CDS to the settlement system ASAP**. Programmed controls ensure the completeness of feeds from CDS/SUMMIT to ASAP.** (However, for non-vanilla CDS trades, SUMMIT is still being used to feed settlement information to ASAP. But that only represents approximately 1% of the entire CDS population). Dynamix has replaced SUMMIT for all Credit Default Swaptions for valuation purposes and is scheduled to replace SUMMIT for CDS by end of fiscal 2008[JW4]

CDS to ASAP Reconciliation

CDS automatically feeds the Automatic Settlement and Payment System ("ASAP"). As both system book to a bridge account, Middle Office ensures that there are no breaks between CDS and ASAP by looking into the CDS to ASAP Exception Report **(B3.B7). MO reviews the**

system generated exception report (CDS/SUMMIT to ASAP) for all breaks. All breaks are resolved timely (B3.B7 and **B3.B7a).** Discrepancies between the two systems could also be caught in the cash reconciliation and post settlement bank reconciliation (Refer to the GSSR reconciliation section below). SUMMIT is still in use for non vanilla CDS trades which represents about 1% of the total population (The current year trade is a vanilla trade and will not held in SUMMIT). Depending on where the trade sits, respective breaks will appear on either the CDS to ASAP or the SUMMIT to ASAP reconciliation.

All breaks are resolved timely. Standard settlement instructions from the trade are also fed from Entity Master to ASAP. ASAP is responsible for generating notices and processing payments for all fixed income derivatives (See **B3.B2** for ASAP Payment Screen). **Payment instructions are automatically fed from Entity Master to ASAP and authorizations are required to overwrite them in ASAP.** ASAP then feeds GCCM which is a queuing system where the SWIFT payment messages, Lehman's payment dispatch system, are held until authorized by Treasury and sent to the agent bank. (See **B3.B2a** for SWIFT message screen), which sends a message to the agent bank. Swift messages are sent through GCCM and no longer through ASAP. The GCCM Nostro Account Statement screen can be viewed to verify if the payment has gone out successfully (See GSSR walkthrough in Equities GAMx at **B13**). Manual payment entries can also be made in ASAP (**B3.B2b**); but they need to be approved by supervisors before they can be processed. An MIS report can be run to identify the person who puts in the entry and who approves it.

DTCC Warehouse Settlement

Trades that are settled through the DTCC Warehouse (see **B11.Memo.DTCC** for further detail) are booked to a dummy entity (LCLS or LBCL, the equivalent of LBSF and LBIE respectively) to ensure the payment bypasses the SWIFT messaging system. Per conversation with Patricia Nist, 10% of daily payments and 40% of quarterly payments are settled through the Warehouse. The first coupon payment of the assigned trade was settled in the Warehouse, therefore settled through the CLS process (see **B3.B9** for the ASAP payment confirmation). Payments settled in the Warehouse flow through to TLM.

For trades processed through DTCC, breaks between general ledger files and the bank accounts will appear on the daily TLM reconciliation report also reviewed by the Derivatives Settlement group **(B3.B10).** This reconciliation matches ITS journal entries from ASAP to the DTCC net payment entry sent from GCCM.

ASAP also feeds International Trading System ("ITS") journal, which contains the books and records of all products (See B3.B3 and B3.B3a). **Journal entries are automatically booked in ITS by ASAP upon payment/receipt.** ITS automatically generates a two-sided journal entry in order to reflect the cash movements and settlement that occurred via ASAP.

ASAP has a payment tracker function that tracks the payment. It details when the payment was confirmed and released to treasury, as well as its source of funding. ASAP settles CDS deals in all currencies. Queries are run on a daily basis to identify what trades are due to settle. If there

is a discrepancy, the settlement department contacts the Middle Office, the traders, and the client.

Prior to settlement, Lehman can confirm payment details prior to settlement in one of four ways:

- eSAP, a web-based version of ASAP, (see **B3.B5**)
- DTCC (used for Credit Derivative transactions only) real time trade system which reconciles trades with the street (see **B3.B4 , B3.B4a**).
- Lehman personnel personally calling the counterparty to confirm
- eClerx, an India-based company which performs pre-settlement confirmation as well as settlement services

The counterparty can directly confirm the payment through eSAP, a web-based version of ASAP. It's only available to those counterparties who have signed up for eSAP. Approximately 15% of all counterparties use eSAP to verify their own payment information by using this online Lehman service. DTCC is a real trade time system that reconciles trades with the street. It is used as a confirmation tool only for credit derivative products. It is highly automated and identifies errors for correction immediately. Andrew Kayiira, Fixed Income Operations, confirmed as of 7/22/2008 97% of all eligible trades are confirmed through the DTCC Deriv/SERV. (See **B3.B4, B3.B4a, B3.B4b** for the DTCC Screenshots and see DTCC walkthrough memo at **B11.Memo.DTCC** for further details surrounding DTCC).

For other counterparties with which Lehman conducts business, either eClerx or their own staff will perform confirmation procedures. The eClerx staff in India will confirm payment information directly with the counterparties. eClerx primarily is used to handle pre-settlement confirms and then to ultimately confirm payments in ASAP. When eClerx finds an issue or a discrepancy, they follow up directly with either the counterparty or Lehman Brothers, depending on who can claim ownership for the issue. Subsequently, the responsible party will make any necessary corrections and the payments are then considered confirmed. Lehman has a pre-settlement rate of approximately 50%.

GSSR Reconciliation (Global Smart Stream Reconciliation)

All discrepancies between the general ledger files and the bank accounts are included on the daily bank reconciliation report. Bank reconciliation discrepancies occur on a daily basis, and are communicated to the settlement group. Nostro reconciliations, which capture mistakes in funding, are also performed in GSSR. **Reconciling items on the GSSR exception based bank reconciliation report are investigated and cleared timely by the Derivatives Settlement group (B3.B6).** The GSSR Reconciliation process is a cross-product process and as such is being walkthrough separately on its own. Please refer to the Equities team GAMX engagement for further information on the walkthrough at **B13**.

VIII. Estimated v. Actual (PC Cash Reconciliation)

E&Y auditors spoke with Nina Chand, Todd Brooks, and Qwasi Garner of Lehman Brothers

Product Control and obtained the cash reconciliation performed by product control for the HYC business. Until 7/3/08, the cash reconciliation was a manual process where Nina and her team of product controllers worked with the middle office/settlements group to investigate and correct cash breaks that occur at each month end. **PC performed this reconciliation at each month-end close in order to review and reconcile outstanding cash breaks between PALS (expected payment) and ITS (actual).** See **(B3.B11)** for Summary of Breaks for 5/30/08. Cash breaks for this area are housed in deferral accounts within the 11081[JW5] account range. The main reasons for breaks are related to timing differences, allocation errors, booking errors etc. See **(document for 5/30?)** for a sample of breaks and subsequent clearance selected by EY for walkthrough purposes.

As of 7/3/08, Lehman went live with an automatic reconciliation process driven by TLM. Breaks resulting from the TLM automated reconciliation will continue to be manually corrected. See (document) for the 7/31/08 PALS to ITS reconciliation. (obtain July rec and observe ITS download for July, GFS does not retain dated reports, therefore, EY was not able to observe the 5/30/08 download).

Prior to the transition to TLM, timing differences accounted for approximately 75% of all cash breaks for HY/HG Credit products. Timing differences are caused by differences in either PALS, which projects the required amount of cash to be transacted, and ITS which accounts for actual cash that flows related to the business. Please see (for July only) **document** and **document** for ITS data and PALS data, respectively. Breaks occurring with the TLM generated reports are primarily due to allocations, assignments and counter party discrepancies. See **(document)** for clearance of breaks for the 7/30/08 report.

One of the main reasons for the breaks driven by ITS is that ITS operates on a two day lag, therefore cash that is realized on the last day of the month will not be recorded by ITS until two days after the close of the period. Nina explained that she defers the entries related to cash realized on the last day of the month and reverses these entries once ITS records the cash.

Allocation errors occur when a large cash payment is received in ITS from one counterparty, however, is booked on a piecemeal basis in different accounts for the same counterparty in PALS. These breaks normally occur for example when a hedge fund enters into a trade and later the trade is divided into several components and booked into different accounts pertaining to the customer. A single cash payment will flow in ITS without being specifically attributable to a single account. Product Control investigates the breaks and determines the specific cash allocation to each of the accounts. PC then communicates their findings to the settlements group which will journal the cash in the following month to rectify the difference.

Because there are so many outstanding deals in the HY/HG Credit area, the ITS and PALS information is housed in a large Microsoft Access database. At month end, the two data sets are compared side by side (by Deal ID), and are netted out. Mirror trades are matched off, and transfers are as well. What is left is fed into a Microsoft Excel file **(B3.B11 and TLM report)** with all breaks that need to be investigated by Product Control. Product Control always

chooses the largest YTD breaks and works their way down from there. The process is highly manual at this point.

Below are the typical journal entries which would be made for deferring the P&L in case there is a difference between the cash receipt forecasted by Lehman Model`s and actual cash receipt through ITS.

1] Initial Entry:

Dr. Receivable	$50	
	Cr. P&L	$50

(To record the derivative receivable and recognize the revenue)

2] Actual Cash Receipt Entry (Actual<Projected):

Dr. Cash	$9	
Dr. Timing/Deferral	$1	
	Cr. Receivable	$10

(To record the difference between the actual cash receipt of $9 and the projected cash receipt of $10 in the timing/deferral account which is deferred)

3] Balance cash receipt Entry:

Dr. Cash	$1	
	Cr. Timing/Deferral	$1.

(To record the balance cash receipt and reverse out the timing/deferral account)

The net effect of the above entries would be that receivables will be at $40. Cash will be at $10 which is the actual cash receipts in two installments and the timing/deferral account will be zero.

Scenario in which Lehman doesn`t receive the cash: Here there can be two situations i.e. whether Lehman has a good receivable or a bad receivable. If it`s a good receivable then the balance would be kept in the deferral account until they receive it. If it`s a bad receivable then the balance would keep sitting in the timing/deferral account and the reason for the break has to be researched and resolved as to why there is a gap in both. If it`s a bad receivable which means that the model forecast was off a footnote entry adjusting the P&L has to be passed. The first two entries would be the same but the third entry would change as follows:

3] Balance loss receipt Entry:

Dr. P&L	$1	
	Cr. Timing/Deferral	$1.

(To record the P&L impact of a bad receivable and reverse out the Timing account)

Below are the typical entries which would be made for deferring the P&L in case the P&L is timed out or deferred for any of the reasons discussed above:

1] Initial Entry:

Dr. Receivable $50
Cr. P&L $50
(To record the derivative receivable and recognize the revenue)

2] Deferral Entry:

Dr. Timing/Deferral $50
Cr. Receivable $50
(To Time out the P&L due to various reasons)

3] In case 100% of the timed out or deferred P&L has to be written off:

Dr. P&L $50
Cr. Timing/Deferral $50.
(To record the balance cash receipt and reverse out the timing/deferral account)

IX. Credit Approval/Credit Risk

The Credit Risk Management process is a cross-product process and as such is being walkthrough separately on its own. For further details on the process, and associated WCGW's and related controls, please refer to the Credit Review Process Walkthrough at **CRP** and the Credit Approval Process Walkthrough at **CAP** in GAMx.[JW6]

X. Daily P&L/Flash to GL Reconciliation

The Credit business encompasses the following material segments – HG Credit: (1) Short Term Credit US, (2) Hybrid Capital, (3) Flow Trading , (4) HG Credit Strategy, (5) Yankee Credit Trading, and (6) HG Loans. E&Y walked through the Daily P&L process for HG Flow Trading but the process for the different segments is very similar in nature for both HY and HG (see **B3.C1 - 4**).

E&Y met with Nina Turner (High Yield) and Todd Brooks (High Grade) in the Credit Product Control (PC) to walk through the daily P&L process for Flow Trading. EY selected the High Grade book IndexJP on 5/2/2008 for walkthrough purposes. This is the trade date and book where the trade selected for our walkthrough is held.

Daily P&L

The P&L is calculated on a one day lag. First, PC downloads the trade level P&L information from PALS. This P&L download contains the explanatories on a trade level. PC copies this information from PALS into an excel spreadsheet and runs a macro to create a Detail Report tab that includes book level explanatories (See **B3.C2**). The macro also creates a product summary tab that contains the P&L for the day (see **B3.C3 2/).** Prior to emailing the P&L summary to the trader, PC reviews the various P&L explanatories for accuracy. **Product**

controllers perform attribution analysis which attributes P&L to market factors via GREEKS (theta, Credit PV01 and Market PV01) thus ensuring consistency with market movements and traders' estimates (See **B3.C2 2/).** PC also looks into any high "Unexplained" P&L that is not being explained by the system.[JW7] Daily P&L reports are sent to each trader, a soft policy threshold for HY/HG CDS is $5,000 per trader for unexplained P&L. [JW8]

PC performs research based on the trade level information from PALS, CDS and SmartTicket. As a result of this analysis, PC will make a timing adjustment in PALS to hold out incorrect P&L if necessary.

PC compiles the P&L for all business segments, documents, and distributes the Global Daily Highlights report to senior management (see **B3.C3 1/**). Matt Karp of Finance is responsible for consolidating the P&L data for all HY and HG business segments for this report. This Global Daily Highlights report has the estimated and actual P&L, and brief highlights of the major components of each. In addition, Todd Brooks, AVP of Credit Product Control, compiles and emails a similar summary at the end of the day with the actual P&L information to the trader (**B3.C4**). **PC creates the P&L summary email derived from the PALS Detail Report (**see **B3.C2 1/), the PALS Product P&L Report (**see **B3.C3 2/) and the Quest Report (**see **B3.C3 3/) to ensure that the P&L amount between PALS and Quest agree.**

Reports highlighting risk information are created daily by Nidhi Bhatia of Global Risk Management and sent to PC, Risk Management and the certain individuals at the Desk. These reports are purely exposure in nature and are created from an ICE data dump into Access where Nidhi then runs a series of macros to organize the data into desired reports. Notices for daily reports are sent via email to a pre-populated group of recipients. SRTS, Supervisory Review, tracks which recipients have reviewed the reports. As of 7/31/08, Lehman's Flow Desk went live with Insight, a new system with the capability of creating risk related reports to the specifications of individual users. Daily reports are not generated through Insight since the system is interactive and allows users to create reports as desired. The expected launch date for HY/HG CDS is XX[JW9]. The use of this new system negates the purpose for the previously manually created reports by Global Risk Management which were stopped as of 7/23/08.

(1) CDS to DMS:

On a daily basis, CDS feeds DMS which then feeds PALS with P&L and position information (See **B3.A8** for DMS screenprint). **A reconciliation between CDS and DMS (**see **B3.A9) is performed by Middle Office for inter-company deals. All breaks are investigated and resolved timely**. The report covers Risk Management System (RMS) such as CDS, SUMMIT, and Dynamix. All products feed into RMS, therefore, credit default swaps are not the only products to appear on this report. CDS and DMS are reconciled for inter-company transactions only, not for trades with the street. Discrepancies will come up as a result of the reconciliation and will need to be resolved by Middle Office. Breaks typically occur because trades are not mirrored correctly and/or accounts are not set up properly. When trades are not mirrored

correctly Middle Office can make those changes immediately to clear the break. The second type of break occurs when a CDS account is not set up or mapped properly in Pathfinder. Finance is responsible to map the accounts so when a break occurs Middle Office will notify them and they will resolve the issue. All trades within DMS feed position and P&L information into PALS. **Programmed controls ensure completeness of feeds from DMS to PALS.**

(2) PALS to Quest:

As PALS is Lehman's derivatives P&L system, it does not have any Cash/Bond P&L, which is automatically fed from Quest for completeness purposes. On the other hand, Quest, which is the firm-wide P&L system, does not have the derivatives P&L. P&L for derivatives are manually fed into Quest by way of ampersand "&" footnotes for completeness purposes**.** At the end of the day, P&L in both the systems PALS and Quest should agree. **Product Controls reconciles P&L in PALS to Quest on a daily basis (B3.C5 to be obtained).** Todd Brooks reviews this report for HG Credit, all breaks are uploaded to Quest. Rarely will a break not be upload to Quest, an example of this would be a new account in PALS which does not exist in Quest. However, only cash per Quest (through ITS) and derivatives P&L per PALS feeds the G/L. Cash in PALS and Derivatives in Quest are in dummy accounts and do not feed to G/L**.** Product Control ensures that the sum of the total P&L for cash, derivatives and synthetic pieces agree with the final PALS P&L detail report for the day.

Flash to GL Reconciliation

The Flash to G/L Reconciliation testing is performed by Product Control on a monthly basis to ensure that the P&L that is captured in their daily P&L processes properly hits the books and records of the firm (DBS).

(2) Quest to DBS:

First, Product Control verifies that the P&L that is flashed in PALS agrees with the P&L that is reported in Quest. Product Control will make any manual adjustments in Quest, where needed, to agree to the P&L reported in PALS. **Product Control then verifies that the flashed P&L in Quest is properly captured in the G/L (DBS) through a Flash to G/L Reconciliation.** This Reconciliation provides the G/L P&L, the Quest P&L (which agrees to PALS), and the deferrals booked to agree the G/L P&L to the PALS P&L. See (**B3.C1**) for Flash to G/L reconciliation summary for 5/31/2008. The threshold for breaks in the Flash to G/L Reconciliation is $250,000. These breaks are usually cash related and should therefore match the breaks uncovered in the PC Cash Reconciliation.

P&L Timing Adjustments

EY auditor has taken a cross-product approach for the PALS Timing Adjustment process. A separate walkthrough has been performed for PALS adjustments for all products. Please refer to **B8.**

P&L Roll Up Process

For details on how the P&L number rolls-up to the income statement refer to the FSCP Memo in Corporate team's GAMx engagement. On T+1, the Product Control group verifies MTM and P&L with the Traders to make sure all trades were captured in risk management systems. Any discrepancies between the traders' calculation and the systems are investigated, explained and cleared timely.[JW10]

Statement 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, provides financial statement disclosure guidance for Lehman's Fixed Income and Derivatives business. EY performs a walkthrough of this process. Details on the P&L rolls-up to DBS from the different sub ledgers (ITS, MTS, TMS), is covered in the FAS 105 walkthrough. This process also address various system feeds, such as SUMMIT and CDS, into DMS. The FAS 105 walkthrough can be seen at **B13** in GAMx.

XI. Valuation (Price Verification)

E&Y auditors met with Scott Goswami, Supurna Ray, and Gilles Aublin, to discuss the month end HYC and HGC price testing process. **Product Control independently reprices the trading portfolio using observable market data obtained from independent sources in accordance with the Firm's Price Verification Policies (B3.D HY** and **B3.D HG).** The HYC and HGC populations are price tested to ensure that Lehman's inventory is marked to fair market value in accordance with Lehman's Price Verification Policy and Procedure. **Price Testing Methodology is documented, approved and reviewed by management.** As of 5/31/08, a formal price testing methodology is in the process of being documented and waiting to be approved and reviewed by management. A formal policy is expected as of 8/31/08.

The step by step price testing process is as follows:

(1) Lehman curves sent to consensus surveys – MIP

The month-end pricing process begins within the first four days of each month. The global risk information is downloaded in London. This is an automatic download from CDS into the central data depository. The risk information is then manually uploaded to the Price Testing Database (PTDB). Regional ICE data is uploaded into PTDB. As part of the price testing process Lehman submits its prices from ICE to Mark-it Partners. Mark-it Partners receives the prices from various contributors and compiles a composite price for each position. If Mark-it Partner's price is within the bid/offer, it will be accepted as being within range. However, if the price is not within bid/offer range, steps are taken to get an acceptable variance value. Note that EY TSRS in London is responsible to test the feed from MIP: IT General Controls testing around the PTDB, and testing of the feed between ICE and the PTDB. [JW11]

(2) Results returned

Lehman can then download these composite prices from the Mark-it Partners website into an

excel spreadsheet. Lehman will get back prices for only those curves for which it originally contributes prices. Mark-it Partners provides price for only certain maturity buckets, e.g. 1Y, 2Y, 3Y, 5Y and 7Ybuckets etc. The prices for the remaining maturities like, 4Y and 6Y will be obtained by a process of interpolation in the excel spreadsheet. Mark-it Partners is the primary source (approximately 90 percent) for external prices due to change in speed of results. Other sources include recent trading history from Bloomberg ,while the outstanding quotes are obtained from alternative procedures. Lehman critically reviews the data received from MIP and considers reasons for material variances. Note that EY TSRS in London has performed testing of the feeds from Mark-it Partners and Lombard into PTDB. No ineffective were noted[JW12]

(3) Results compared to Lehman levels

When the data is received from the consensus survey a couple of steps are performed to the data:

- Interpolation - The risk is stored in year buckets up to the 10Y point but from MIP Lehman only gets back 1Y, 2Y, 3Y, 5Y, 7Y, 10Y. Therefore they interpolate the 4Y, 6Y, 8Y and 9Y points from the data they have received[NMK13]. They use a straight line method.
- Extrapolation[NMK14] – as opposed to the interpolation, Product Control creates points non-readily available outside the existing curve, mostly for points before 1Y. However, E&Y notes that Lehman is actually using the level provided for the closer point quoted. For example, the external level for 3M uses the 6M point. This approach is conservative. In addition, E&Y noted that there was no significant risk associated to the extrapolated points.
- Doc clause basis (also called "backwardation") – PC performs this process to report two variance numbers using the original consensus/brokers number and a "Synthetic number". There are a number of different clauses relating to how you treat a default swap on the reference entity going through restructuring. The clauses mean there are varying amounts of restriction as to what can be delivered if triggered by restructuring. These vary from no restriction to some degree of being able to trigger on restructuring. As the restrictions decrease, one could receive more money for writing the protection. This means that the curves for an issuer should always maintain this relationship Old-Re>Mod-RE>Mod-Mod-Re>No-Re because Old-Re is the easiest to trigger default/bankruptcy and therefore is the most the expensive. In Europe the current traded clause is Mod-Mod-Re and in America it is Mod-Re. The consensus survey can give back data where Old-Re<Mod-Mod-Re, therefore Lehman has to perform the backwardation analysis to ensure that the Old-Re>Mod-Mod-Re relationship is maintained and the revised curves are used to calculate the "Synthetic" variance. Please refer to step 4 for meaning of each clauses.

Note that a consensus survey is the average of the contributions. The categorization of liquidity is dependent upon the number of contributors and is listed in the price testing population. A large quantity of contributors with a wide variation of positions will result in more liquidity and

a greater tolerance level. (see **B3.D HG 3/** and **B3.D HY 3/**):

- Liquid - >9 contributors
- Semi - 6 to 9 contributors
- Illiquid – 4 to 5 contributors
- V.Illiquid – 2 to 3 contributors

A pivot table is created from this excel file with the interpolated prices and is then uploaded to the PTDB. After the prices are uploaded in the PTDB, the backwardation process takes place to ensure consistency of the various Doc Clauses. Product Control is also responsible to reconcile ICE and PTDB population to ensure that the PTDB population is complete. E&Y noted the New York product control no longer performs this reconciliation. EY auditors have noted this as a deficiency (please refer to the SOCD). Product Control ensures the PL2 levels that are pulled from ICE and price tested are the same PL2 levels that are included in Pathfinder for the HG/HY Credit business (**BHYC 4a.1**). There is no risk/exposure tie-out between the price testing file and Quest.

E&Y also selected a sample of trades price-tested using Markit (see **B3.D HG 4/** and **B3.D HY 4/**) and obtained the Markit Partners Data that agreed to the external levels that PC use for the price testing without exceptions.

[NMK15]

(4) Variances between curves applied to Risk along the curve

This PTDB file with the variance is sent to the various regions, NY and Asia for investigating the material variances. Product control in the regions is responsible to investigate their respective variances.

E&Y recalculated Lehman's price variances between valuing with the traders' credit spreads and the external provider's spreads by comparing the two spreads for each selected ticker and then multiplying any resulting variances by the respective CR01 (see **B3.D HG 3/** and **B3.D HY 3/**).

Please note that the price testing is comparing Lehman's "external level" by fourtuple to the markets "external level" by fourtuple. PTDB file provides risk curve status based on fourtuple. For illustration purpose, the following fourtuple "BSC.USD.Senior.Deriv" can be read as follows:

- BSC – credit/ticker of the issuer
- USD – currency of the security
- Senior – class of debt (i.e. Senior, subordinate, preferred or secondary)
- Deriv – type of transaction (i.e. CD Swap)

Some fourtuple also includes a restructuring clause, like the following fourtuple "DPH.USD.Senior_MODRE.Deriv". This is really similar to the first one, except that "MODRE" which means 'modified restructuring' and refers to the Restructuring Clause of the debt as mentioned in the ISDA clause of 1999, which states that:

- If nothing is specified (like the first example), it implies that there is no restriction on the maturity of the bond if a credit event is triggered.

- With a modified restructuring clause (like the 2nd example), a bond of 16 years or more (standard restriction) can be handed in if a credit event takes place. The credit event can be a chapter 11 filing on anything else.

In most standard default swap contracts linked to a corporate (non-sovereign) reference credit, there are three credit events that can trigger the payment of protection: bankruptcy, failure to pay, and restructuring. Both bankruptcy and failure to pay are called hard credit events because following either, bonds and loans of the issuer should trade at (very close to) the same price. Restructuring is different, and is known as a soft credit event. In order to define what restructuring means in the context of a credit default swap, one must refer to the 2003 ISDA definitions for the four types of restructuring clauses[1]. They are:

1. Old Restructuring (Old-Re)
   Used widely in the US until 2001 and is still the standard in Europe and Asia. The maturity deliverable was 30 years.
2. Modified Restructuring (Mod-Re)
   Standard in the US market. It limits the maturity of deliverable obligations to the maximum of the remaining maturity of the swap contract and the minimum of 30 months and the longest remaining maturity of a restructured obligation. It only applies when the protection buyer has triggered the credit event.
3. Modified-Modified Restructuring (Mod-Mod-Re)
   European standard, it limits the maturity of deliverable obligations to the maximum of the remaining maturity of the CDS contract and 60 months for restructured obligations and 30 months for non-restructured obligations. It also allows the delivery of conditionally transferable obligations rather than only fully transferable obligations. This clause should widen the range of loans that can be delivered. It also only applies when the protection buyer has triggered the credit event.
4. No Restructuring (No-Re)
   This is the removal of restructuring as a credit event leaving just the hard (default) credit events.

Generally, those curves can be derived from each other using some ratios/factors. For example, the Old-Re curve will be 100% of the quoted curve. Then Mod-Mod will be 95% of the Old-Re curve, Mod-Re, 90% of the Old-Re curve and No Re, 85% of the Old-Re curve. Hence, for every reference name (like Ford, IBM), there could be 4 curves reflecting the above restructuring clauses. Lehman used to derive itself the different curves, however, now Markit is providing all of them, unless no quotes were provided.

(5) P&L variances published

This PTD file with variances is sent to the various regions, NY and Asia for investigation.

(6) P&L variances investigated

[1] Extract from Stuart M. Turnbull publication, September 11, 2003

Product control in the regions investigates material variances that are greater than $300K for HG and $500K for HY (in absolute value) per ticker or a high percentage of coverage[NMK16]. The variances are discussed with the desks, which can result in a number of outcomes, two of which are:

- The variance is found to be valid and the trader remarks curve
- The variance is found to be invalid and the trader provides support for his mark, i.e. broker quote or trading activity. If this is the case then this evidence will be fed back into the database so that the variance reflects this.

The main reasons for the consensus curve not being correct usually fall into one of two camps:

- Less liquid names where there maybe a number of smaller less well educated players contributing thus skewing the consensus.
- Errors in the contributions. In the example of MKS, when the bid by Philip Green was announced credit spreads widened dramatically. Now the default swap most traded was the EUR_SENIOR_MMR and the curve on this would be correct. However, if a number of contributors forgot to move say the GBP curve then the consensus returned for this maybe skewed incorrectly as there is no reason for the GBP curve to be different from the EUR one.

E&Y selected a sample of 2 variances above $500K for HY and 1 variance above $300K for HG from the respective Price Verification Summaries (see **BHYC 4A 1/** and **BHGC 2A 1/** respectively) and obtained additional documentation to show PC's investigation and explanation.[NMK17]

As of 5/31/08, a soft policy for variance investigation was in place. Product Control followed a variance threshold of 2 standard deviation points. Variances less than this threshold were waived.

(7) Curves not covered by consensus are covered by Alternative procedures[JW18]

The steps 6 & 7 can result in manual entries to the database.
If Lehman does not get the data back from the consensus surveys then they will need to gather the evidence in another manner. This can include:

- Trade History, referred in Lehman Price testing as "Alt Proc TH"
- Benchmarking curve from bond prices, referred in Lehman Price testing as "Alt Proc DFS", which relates to benchmarking default swaps to price verify the position
- Benchmarking from similar credits
- Broker quotes, referred in Lehman Price testing as either "Alt Proc MIT" or "Alt Proc Bro", which relate to use Markit Partners or brokers quotes to verify the position

Note that in NY and Tokyo, they do the work on steps 6 & 7 locally while the database is run in London and they send them the results files.

(8) Revised P&L variances published again

Results are sent to the regions a final time.

XII. Valuation Adjustments

EY auditor has taken a cross-product approach for the Valuation Adjustment process. A separate walkthrough has been performed for valuation adjustments for all products. Please refer to **B10** workpapers in GAMx.

Confirming our Understanding of Controls (Controls Strategy)

Describe the walkthrough procedures to confirm our understanding of the design of the controls and that they have been placed into operation. As we walkthrough the prescribed procedures and controls, we should ask personnel to describe their understanding of the control activities and demonstrate how they are performed. We keep in mind that controls may be manual, automated, or a combination of both. Application controls are fully automated controls that apply to the processing of individual transactions. IT-dependent manual controls are dependent upon complete and accurate IT processing to be fully effective.

Manual and IT-Dependent Manual Controls

Trade Entry/Trade Capture

Control	*Documentation Obtained*	*Procedures Performed*
1. **Through eClerk, MO obtains daily files containing the reconciliations between Trade Blotter, SmartTicket, and CDS. MO Reviews the reconciliation and resolves any breaks timely.**		
	eClerx Blotter Rec. (**B3.A12**) CDS to SmartTicket Rec (**B3.A7**) eClerx Broker Rec (**B3.B13**)	EY obtained an eClerx reports reconciling the trade blotter to CDS, CDS to SmartTicket, and Broker Report to SmartTicket. No breaks were observed for the selected trade.

Settlement

Control	*Documentation Obtained*	*Procedures Performed*
2. MO reviews the system generated exception report (CDS/SUMMIT to ASAP) for all breaks. All breaks are resolved timely.		
	CDS to ASAP Rec. (**B3.B7**) SUMMIT to ASAP Rec. (**B3.B7a**)	EY obtained the CDS/SUMMIT to ASAP recs.. No breaks were observed for the selected trade.
3. Reconciling items on the GSSR exception based bank reconciliation report are investigated and cleared timely by the Derivatives Settlement group.		
	GSSR screenprint (**B3.B6**)	EY obtained the GSSR Break Report. No breaks were observed for the selected trade.

Estimated vs. Actual (PC Cash Reconciliation)

4. PC performs a reconciliation at each month-end close in order to review and reconcile outstanding cash breaks between PALS (expected payment) and ITS (actual).		
	PALS vs. ITS Rec (**BHYC 2.7**) PALS vs. ITS Break Clearance (**BHYC 2.7.1**)	EY obtained the reconciliations ensuring all payment information properly fed between the systems. EY selected a sample of breaks to walkthrough their clearance.

P&L

Control	*Documentation Obtained*	*Procedures Performed*
5. A reconciliation between CDS and DMS is performed by Middle Office for inter-company deals. All breaks are investigated and resolved timely.		
	CDS to DMS Interco Breaks Report (**B3.A9**)	EY obtained the 5/2/08 CDS to DMS reconciliation. EY notes no breaks between CDS and DMS. this includes our walkthrough sample.
6. Product controllers perform attribution analysis which attributes P&L to market factors via GREEKS (theta, Credit PV01 and Market PV01) thus ensuring consistency with market movements and traders' estimates.		
	PALS Detail Report (**B3.C2 2/**)	EY obtained the PALS Detail Report with explanatories to ensure PC performs attribution analysis establishing consistency with market movements and traders' estimates.
7. PC compiles the P&L for all business segments, documents, and distributes the Global Daily Highlights report to senior management.		
	Daily P&L 5.02.08 (**B3.C3 1/**)	EY obtained the Daily P&L Highlights to ensure management reviews and investigates P&L independently of Front Office.
8. PC creates a P&L summary email derived from the PALS Detail Report, the PALS Product P&L Report and the Quest report to ensure that the P&L amount between PALS and Quest agree.		
	PALS Detail Report (**B3.C2 1/**) Daily P&L 5.02.08 (**B3.C3 2/ and 3/**) Quest Report (**B3.C 3/**)	EY obtained the. PALS Detail Report. Daily P&L 5.02.08. and the Quest Report ensuring all P&L agrees between Quest and PALS.
9. Product Controls reconciles P&L in PALS to Quest on a monthly basis.		
	PALS to Quest Rec (**B3.C5 to be**	EY obtained the reconciliation ensuring all

obtained)	P&L properly fed between the systems.
10. Product Control verifies that the flashed P&L in Quest is properly captured in the G/L (DBS) through a Flash to G/L Reconciliation.	
Quest vs. DBS Rec (**B3.C1**)	EY obtained the reconciliation ensuring all P&L properly fed between the systems.

Valuation

Control	*Documentation Obtained*	*Procedures Performed*
11. Product Control independently reprices the trading portfolio using observable market data obtained from independent sources in accordance with the Firm's Price Verification Policies.		
	HY Price Testing (**B3.D HY CDS Pricing Verification**) HG Price Testing (**B3.D YG CDS Pricing Verification**)	EY repriced a sample of positions in the HY and HG price testing files according to policy.
12. Price Testing Methodology is documented, approved and reviewed by management.		
	Price Verification Policies (**to receive at 8/31**)	EY obtained the price verification policy and ensured the price testing was performed accordingly.

Application Controls

Trade Entry Trade Capture

1. **Smart Ticket has built-in controls to ensure that all key information (i.e. approval) is entered in before it accepts the transaction.**
2. **All new trade tickets and change forms must be authorized by trader to be processed into CDS.**
3. **Middle Office ensures that Smart Ticket information is populated before initiating trade details into CDS.**
4. **After the transaction is reviewed and accepted and allocated to the respective ledgers, it is then sent via straight-through processing (STP) from Smart Ticket to the Credit Derivatives System ("CDS").**

Settlement

5. **Programmed controls ensure the completeness of feeds from CDS to ASAP.**
6. **Payment instructions are automatically fed from Entity Master to ASAP and authorizations are required to overwrite them in ASAP.**
7. **Journal entries are automatically booked in ITS by ASAP upon payment/receipt.**

Estimate vs. Actual (PC Cash Reconciliation)

8. **PC performs a reconciliation at each month-end close in order to review and reconcile cash breaks between PALS (expected payment) and ITS (actual).**

Daily P&L Flash to GL Reconciliation

9. **Programmed controls ensure completeness of feeds from DMS to PALS.**

Section 2: Other Matters—Segregation of Incompatible Duties and Management Override of Controls

Segregation of Incompatible Duties

S03 Understand Flows of Transactions and WCGWs of *EY GAM* requires that we assess the extent to which significant weaknesses in the proper segregation of incompatible duties could increase the likelihood of material misstatements in account balances. Inadequate segregation of incompatible duties also may reduce or eliminate the design effectiveness of a control. Accordingly, we consider whether those individuals performing the procedures and controls observed as part of our walkthrough procedures have any conflicting duties and whether any potential conflicting duties have been addressed in the design of the procedures and controls.

Our considerations related to segregation of duties as part of our walkthrough procedures are documented below:

Was anything noted in our walkthrough procedures that would indicate there are incompatible duties?	No	
If we answered "Yes" to the above: Do the incompatible duties represent a deficiency in the design of controls that is not sufficiently mitigated by other management actions or controls that have been identified (Substantive and Controls Strategy) and tested (Controls Strategy)?	Yes No	Additional Observations
If we answered "Yes" to both of the above questions, provide further documentation and the related effect on our audit strategy.		

Management Override of Controls

S04_Perform Walkthroughs of *EY GAM* requires that we consider whether the results of our inquiries or other evidence obtained during our walkthroughs provides information regarding the possibility of management override of controls or indicators of fraud. The potential for management override of controls is one of the factors that can influence our evaluation of controls, including the effectiveness of internal control at the entity level.

Our considerations related to management override of controls as part of our walkthrough procedures are documented below:

<table>
<tr><td>Was anything noted in our walkthrough of controls that indicate the potential for management override of controls or that such override may have occurred?</td><td colspan="2">No</td></tr>
<tr><td rowspan="2">If we answered "Yes" to the above:
Does the potential for management override of controls represent a deficiency in the design of controls that is not sufficiently mitigated by management actions or controls that have been identified (Substantive and Controls Strategy) and tested (Controls Strategy)?</td><td>Yes No</td><td>Additional Observations</td></tr>
<tr><td></td><td></td></tr>
<tr><td>If we answered "Yes" to both of the above questions, provide further documentation and the related effect on our audit strategy.</td><td colspan="2"></td></tr>
</table>

Section 3: Conclusion

At the completion of our walkthrough procedures, we reach a conclusion on whether our results confirmed our understanding of the flow of transactions or sources and preparation of information. Additionally, if we planned to assess control risk at less than the maximum, we are performing an integrated audit, or the class of transactions contains a significant risk, we reach a conclusion on whether our results confirmed our understanding of whether the controls have been implemented and whether the controls have been designed effectively to prevent or detect and correct material misstatements on a timely basis.

If we are unable to conclude that controls are effectively designed and have been implemented, we may need to reassess our strategy decision (i.e., Controls Strategy v. Substantive Strategy) at the significant class of transactions level and reassess our evaluation of controls. For integrated audits, we determine whether the missing or ineffective control(s) represent one or more control deficiencies that we include on the Summary of Control Deficiencies (EY Form U220).

Our conclusions are documented below or in GAMx (Perform Walkthroughs screen):[2]

	Yes No	Additional Observations
Did our walkthrough procedures confirm our understanding of the flow of significant classes of transactions within significant processes or sources and preparation of information resulting in significant disclosures (Substantive and Controls Strategy)?	Yes	
Did our walkthrough procedures confirm that the identified WCGWs represent the points within the flow of significant classes of transactions, or sources and preparation of information in significant disclosures, where material misstatements could occur (Substantive and Controls Strategy)?	Yes	
Did our walkthrough procedures confirm that the controls have been effectively designed and placed into operation (Controls Strategy)?	Yes	

[2] If any of the situations are noted, we further describe the issues that were noted, and update our process documentation and GAMx file accordingly.