

# LEHMAN BROTHERS

BETH RUDOFKER  
MANAGING DIRECTOR  
GENERAL AUDITOR

July 22, 2008

**To:**            AUDIT COMMITTEE  
                  THOMAS H. CRUIKSHANK, CHAIRMAN  
                  MICHAEL AINSLIE  
                  ROGER S. BERLIND  
                  SIR CHRISTOPHER GENT

ERNST & YOUNG  
                  ARTHUR F. TULLY  
                  WILLIAM SCHLICH

LEHMAN BROTHERS  
                  RICHARD S. FULD, JR.  
                  MARTIN KELLY  
                  IAN LOWITT  
                  HERBERT H. MCDADE III  
                  GERARD REILLY  
                  BETH RUDOFKER  
                  THOMAS A. RUSSO  
                  JEFFREY A. WELIKSON

**SUBJECT:     AUDIT COMMITTEE MEETING**

Enclosed are the materials for the upcoming meeting of the Lehman Audit Committee.  
The time and place of the meeting are as follows:

DATE:            JULY 22, 2008  
TIME:            11:00 A.M. – 12:15 P.M.  
LOCATION:        EXECUTIVE CONFERENCE ROOM (31<sup>ST</sup> FLOOR)  
                  745 SEVENTH AVENUE

Please call me if you require any further information.

Enclosure

LBEX-AM 067609

## AGENDA

### LEHMAN BROTHERS HOLDINGS INC. LEHMAN BROTHERS INC.

#### AUDIT COMMITTEE MEETING

July 22, 2008

Executive Conference Room – 745 Seventh Avenue / 31<sup>st</sup> Floor  
11:00 a.m. – 12:15 p.m.

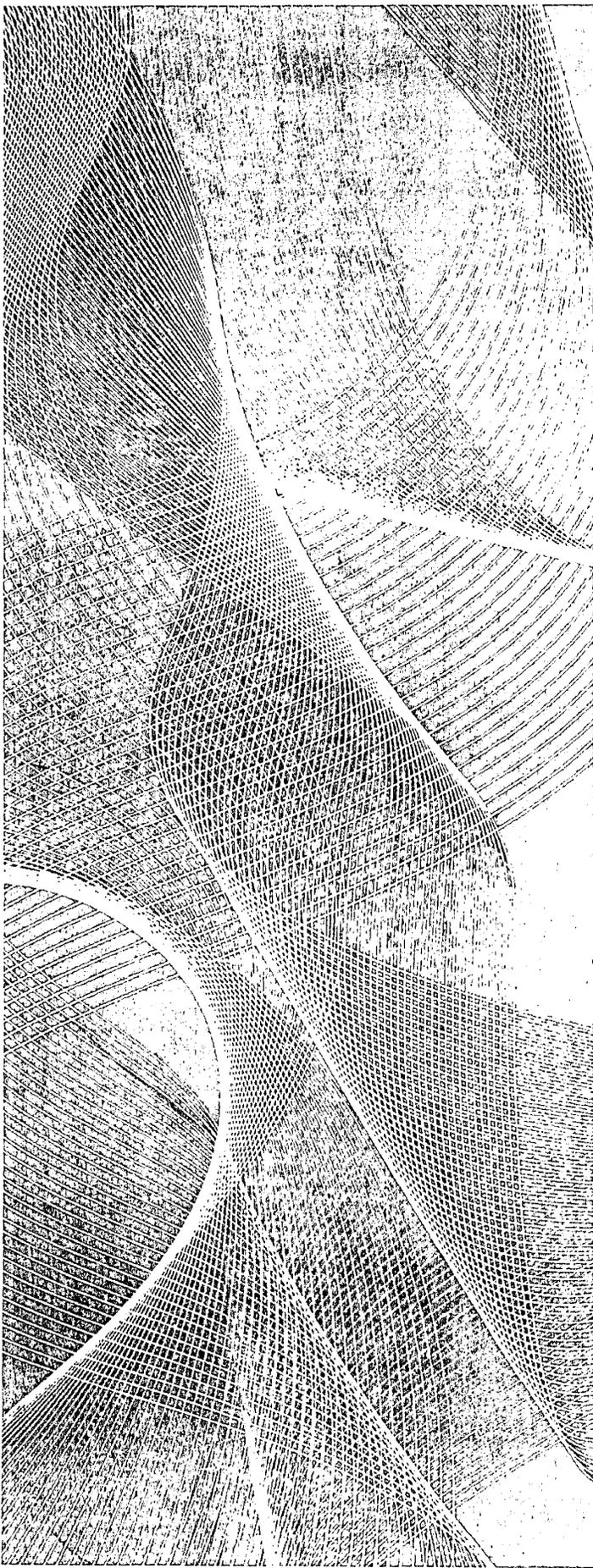
<u>AGENDA ITEM</u>	<u>DESCRIPTION</u>	<u>RESPONSIBILITY</u>	<u>ESTIMATED MINUTES</u>
1.	Approval of Minutes of the July 8, 2008 Meeting	Audit Committee	Nil
2.	Valuation Review	Ian Lowitt / Gerry Reilly	45
3.	European Equity Volatility Review	Beth Rudofker	10
4.	Employee Letter Review*	Beth Rudofker	10
5.	Private Session	Audit Committee	10
		<b>Total</b>	<hr/> <b>75</b> <hr/> <hr/>

*\*Report will be distributed at the Audit Committee Meeting*

LEHMAN BROTHERS

# Presentation to the Audit Committee Employee Letter Review

July 22, 2008



LBEX-AM 067664

Confidential Presentation

# Summary

---

- ◆ Senior Finance and Risk Management of the Firm received a letter dated May 16, 2008 from Matthew Lee, an SVP in the Finance Division responsible for Global Balance Sheet and Legal Entity Accounting.
  - Matthew was an employee of the Firm since 1994 and held several Financial and Product Control positions.
  - His letter indicates that he had “become aware of certain conduct and practices that [he felt] compelled to bring to [management’s] attention, as required by the Firm’s Code of Ethics”.
  - “In the course of performing [his] duties for the Firm, [he has] reason to believe that certain conduct on the part of senior management of the Firm may be in violation of the Code”.
  
- ◆ In summary, Matthew’s concerns largely relate to balance sheet and legal entity controls for which he was responsible and he believes that “it will take a significant investment of personnel and better control systems” in order to address them.
  - Further discussions with Matthew revealed that the letter was the result of his frustration with the level of resources, technology and dependency on other groups needed to fulfill the responsibilities of his group.
  - It should also be noted that he sent the letter just a few days prior to the Firm’s May reduction-in-force. At the time the letter was sent, a decision had already been made to eliminate his position as part of the reduction-in-force and restructure his role to address enhancements that had been identified.
  - Per standard severance practices, Matthew and the Firm have entered into an agreement concerning his separation. The agreement was reached mutually during the following weeks while a thorough review of his concerns was being conducted.
  
- ◆ Upon receipt of the letter, senior management of the Firm met with Matthew numerous times to discuss the six specific points he raised and conducted an evaluation of them.

# Summary

---

- ◆ The Firm's Head of Corporate Audit, General Counsel and External Auditors met with Matthew various times to discuss the details of his concerns, including separate time spent with Ernst and Young without management of the Firm.
  - Corporate Audit has largely completed an evaluation of Matthew's observations in partnership with Financial Control and Ernst and Young.
    - Information received directly from Matthew has been reviewed along with additional data and support obtained directly from control sources.
    - While the daily management balance sheet and quarter-end substantiation processes mentioned in Matthew's letter are important secondary controls, they are not relied upon as part of annual Sarbanes-Oxley audit testing due to previously identified gaps.
    - As a result, internal and external auditors test and rely directly upon the sources of upstream primary control processes and reconciliations when evaluating the Firm's financial statement controls.
    - Knowledge of these primary controls from prior audit testing was leveraged as part of this review.
  - Financial Control and Corporate Audit management evaluated the specific processes and controls mentioned in Matthew's letter and agreed to a set of enhancements that are currently being implemented. This includes:
    - Elimination and restructure of certain processes that were not adding value
    - Policy refinements, clarification and organizational reinforcement
    - Continued technology enhancements
- ◆ No material issues have been identified during the review and this report to the Audit Committee summarizes the findings and recommendations.

# Point #1 – Daily Management Balance Sheet

---

- ◆ Matthew points out that “the Firm manages its balance sheet assets on a daily basis”. This daily management balance sheet is, in fact, an estimate that the business, Product Control and senior management use to monitor and guide daily decisions around the Firms inventory assets.
- ◆ The daily management balance sheet is not the Firm’s books and records but is reconciled to the general ledger at month end by the group for which Matthew was responsible.
- ◆ According to Matthew’s letter, “on the last day of each month, the books and records of the Firm contain approximately five billion dollars of net assets in excess of what is managed on the last day of the month” and states that he believes:
  - “this pattern indicates that the Firm’s senior management is not in sufficient control of its assets to be able to establish that its financial statements are presented to the public and governmental agencies in a “full, fair, accurate and timely manner.”
  - “the result is that at the end of each month, there could be approximately five (5) billion dollars of assets subject to potential write-off.”
- ◆ Since the daily management balance sheet is an estimate that management uses in the absence of a daily general ledger, it is important that the reconciliation to the month end books and records does not result in material differences in balance sheet terms.
  - The differences are not material according to the data provided by Matthew shown on the following page and ranges from +0.2% to -1.5% over nine quarters .
  - Differences between the daily estimate and month-end general ledger do not categorically imply or lead to P&L adjustments or write-offs.
  - Management of the Firm, Corporate Audit and Ernst and Young rely upon the Firms extensive set of month end books and records controls and testing of those processes, not the daily estimate.

# Point #1 – Daily Management Balance Sheet

## DMBS v. DBS Analysis TOTAL ASSETS

<u>\$mm Period</u>	<u>Daily</u>	<u>DBS G/L</u>	<u>Variance</u>	
			<u>\$</u>	<u>%</u>
Q1 2008	782,872	786,035	(3,163)	-0.4%
Q4 2007	685,717	691,063	(5,346)	-0.8%
Q3 2007	653,307	659,217	(5,910)	-0.9%
Q2 2007	597,412	605,861	(8,449)	-1.4%
Q1 2007	553,814	562,283	(8,469)	-1.5%
Q4 2006	504,598	503,545	1,053	0.2%
Q3 2006	472,373	473,737	(1,364)	-0.3%
Q2 2006	451,112	456,202	(5,090)	-1.1%
Q1 2006	436,760	439,796	(3,036)	-0.7%

# Point #1 – Daily Management Balance Sheet

---

## ◆ Daily Balance Sheet Management Reporting Process

- The Finance Division Daily Management Balance Sheet group produces an estimated daily balance sheet. As mentioned, it is not considered books and records, nor has it been represented as anything more than an estimate.
- On a daily basis data is pulled from the balance sheet system (GFS) that takes feeds from some of the Firm's inventory and settlement systems. A high level of analysis is performed and manual adjustments are considered. It is used by management as a proxy for actual gross and net assets.
- At month-end, Daily Management Balance Sheet group also produces a month-end version of daily balance sheet, using the same high level approach as described above. This too is an estimate.
- The month-end daily balance sheet is reconciled at a high level to the month-end consolidated balance sheet produced by the Finance Division Consolidations group. This reconciliation occurs after the Consolidations group has finalized all entries and validated postings to source data.

## ◆ Conclusion

- There are sufficient controls in place and they are operating effectively to support the completeness and accuracy of the Firm's month-end balance sheet.
- In conjunction with Sarbanes-Oxley 2007 Audit Coverage and the 2007 Annual Audit Plan, significant audit work has been performed over Balance Sheet controls, including at the Consolidated Financial Statement Level, the Product Level and the Firm Level.
- No material weaknesses were noted that would have an impact on the Firm's financial statements.
- It is important that reconciliation differences between the daily estimate and month-end balance sheet remain immaterial. Corporate Audit supports Finance's continued efforts to implement technology enhancements in order to streamline and reduce reliance on manual processes and mitigate the systemic causes of these differences.

## Points #2, 4 &5 – Balance Sheet Substantiation and Resources

---

### ◆ Point 2

- According to Matthew, the Firm has an established practice of substantiating each balance sheet account on a quarterly basis.
- He observed that “the Firm has tens of billions of dollars of unsubstantiated balances, which may or may not be “bad” or non-performing assets or real liabilities.”
- And states that “The Firm’s senior management may not be in a position to know whether all of these accounts are, in fact, described in a “full, fair, accurate and timely” manner, as required by the Code.”

### ◆ Point 4

- In addition, Matthew “does not believe that the Firm has invested sufficiently in the required and reasonably necessary financial systems and personnel to cope with this increased balance sheet...as a result of the Firm’s rapid growth since...1994.”

### ◆ Point 5

- Matthew also indicated that he does “not believe that there is sufficient knowledgeable management in place in the Mumbai, India Finance functions and department. There is a very real possibility of a potential misstatement of material facts being efficiently distributed by that office.”

## Points #2, 4 &5 – Balance Sheet Substantiation and Resources

---

- ◆ Corporate Audit performed a review of the balance sheet substantiation process for first quarter of 2008.
- ◆ In addition, controls resource levels and responsibilities supporting the substantiation of balances were reviewed.
  - For February 2008 quarter end, the Legal Entity Control Group reported the following levels of balances on an absolute value basis:
    - Unsubstantiated – \$34.6 billion
    - Substantiated with exceptions – \$17.7 billion
    - Rejected – \$31.4 billion
  - Corporate Audit performed a review of the accuracy and completeness of balances reported in these unsubstantiated, exception and rejected categories.
    - The review focused on what was “unsubstantiated” to Matthew’s group, meaning that support for the account was not provided to his group within the timeframe set by the group for the rest of the Firm.
    - Additional supporting documentation was obtained and balances were mapped to control processes performed by various Finance and Operations groups and tested by Audit to further support the balances reported in these categories.
  - As a result of this review, the unsubstantiated, exception and rejected balances were reduced to as follows:
    - Unsubstantiated – \$1.5 billion or 0.2% of total assets (after eliminations and net-downs)  
*See summary on the following page*
    - Substantiated with exceptions - \$3.1 billion or 0.4% of total assets (after eliminations and net-downs).
    - Rejected – \$3.3 billion or 0.4% of total assets (after eliminations and net-downs).
- ◆ Draft control recommendations have been discussed with Finance management.

# Points #2, 4 &5 – Balance Sheet Substantiation and Resources

- Below is a summary of the review results of the “unsubstantiated” balance.
- Of the \$34.6 billion absolute value balance provided by Matthew, \$20.2 billion was for intercompany accounts that are eliminated at the Firms consolidated level, support was obtained for \$15.5 billion and accounts were mapped to control testing processes for \$3.3 billion.
- The remaining \$1.5 billion is 0.19% of total assets (after eliminations and net-downs).

	<u>Net Balance</u>	<u>Absolute Value Balance</u>
<b>Original Balance</b>	2,537	34,641
Intercompany Eliminations	468	13,018
RSU Accounts - Offset	(1,385)	1,386
<b>Original Less Intercompany/RSU</b>	<u>3,454</u>	<u>20,237</u>
Additional Support Obtained	2,879	15,470
Covered by Process Controls Tested by Audit	233	3,290
<b>Total Additional Support or Covered</b>	<u>3,113</u>	<u>18,760</u>
<b>Remaining Balance to be mapped</b>	342	1,477
Total Assets (after eliminations and net-downs)	786,085	786,085
<b>% to be mapped</b>	<b>0.04%</b>	<b>0.19%</b>

# Points #2, 4 &5 – Balance Sheet Substantiation and Resources

---

## ◆ Balance Sheet Substantiation Process

- At month end, the Finance Division Consolidations group, for which Matthew was responsible, produces the consolidated balance sheet from the Hyperion system, which is sourced from DBS, the Firm’s general ledger. There is a robust process in place to produce the month end balance sheet. The entire cycle of producing the final month end balance sheet occurs over a 13 day period, with Consolidations having primary responsibility for final review.
- The process includes the following steps:
  - A nightly batch cycle is run to process journals, balances and transactions from the general ledger to Hyperion for consolidation purposes. There are system controls in place to ensure that data is fed completely and accurately to Hyperion.
  - Hyperion eliminates intercompany accounts that have been designated for auto-elimination. The Consolidations group runs and reviews various reports to ensure intercompany breaks for these accounts are minimized (by contacting the appropriate LEC to clear any breaks), prior to finalizing the balance sheet.
  - Certain intercompany balances, such as cusip netdowns, trade date accrual netdowns, and various other receivables/payables are manually eliminated by the Consolidations group based on submissions from Legal Entity Controllers (“LECs”). Differences are followed-up with LECs and summarized on a ScoreCard Report presented to senior management for review.
  - All manual journals that are submitted for posting to the balance sheet after the 8th business day of the month must be approved by authorized members of the Consolidations group via the Journal Validation Engine tool. This tool routes entries for approval prior to posting.

# Points #2, 4 &5 – Balance Sheet Substantiation and Resources

---

## ◆ Balance Sheet Substantiation Process (continued)

- The Finance Division Legal Entity Control group, for which Matthew was responsible, has primary responsibility for maintaining oversight of the Balance Sheet substantiation process. Accountability for substantiation is assigned to Legal Entity Controllers (“LECs”).
  - LECs are required to substantiate all balance sheet accounts in all legal entities, at least quarterly, with support from Product Control, Treasury and other departments. To substantiate balance sheet accounts, LECs analyze the composition of the balance and obtain reconciliations or other supporting documentation to verify the accuracy and completeness of the balance. This includes supporting all system feeds, journal entries, etc. booked to the general ledger balance sheet account.
  - To assist LECs in their substantiation process, a Substantiation Control Group (SCG) was established in Mumbai, India to review substantiation documentation for accuracy, completeness and consistency across entities and regions.
  - In addition, an application was developed, the Legal Entity Period End Assertion Application (LEMAP) to assist LECs in completing their period-end substantiation process. The substantiation functionality within LEMAP allows LECs to attach documentation supporting the balance in each account, which is reviewed by SCG. The LEMAP substantiation page remains open for approximately 45 days after the quarter end balance sheet closes.
- Within the substantiation process, an account can be assigned with the following status:
  - Substantiated – LEC obtains the appropriate reconciliation/supporting documentation and the amount in the supporting documentation agrees to the GL balance; LEC uploads the document and a review is performed by SCG, who concur based on review guidelines established by the LE Control Committee and denotes account status in LEMAP as “Substantiated.”

## Points #2, 4 &5 – Balance Sheet Substantiation and Resources

---

- Substantiated with Exceptions – LEC tries to substantiate the account balance, however, there is a problem of some kind (i.e. partially supported) and an action plan is created to resolve it.
  - Rejection – SCG has received supporting documentation from LEC, however, the documentation is not sufficient (i.e. does not meet supporting documentation guidelines, does not agree to the balance in the account)
  - Unsubstantiated – SCG has not received anything from LEC to support the balance.
- The processes to follow-up on the various status levels has proven challenging due to the volume of entities, accounts and balances.
  - In addition, reporting is not robust to track the status of substantiation at a point in time, dollar thresholds have not been established to focus on significant accounts and balances, a formal global substantiation policy has not been issued and guidelines for substantiation have not been consistently rolled out.

### ◆ Conclusion

- The substantiation process is in need of improvement. The process is manual and time consuming, and the standards for substantiation have not been effectively determined and communicated.
- As mentioned, this process is not relied upon by Corporate Audit or Ernst & Young as a primary control. Corporate Audit conducts extensive testing of the controls over financial reporting with a focus on primary controls. The testing approach and coverage is described in the next section of the report
- Ernst & Young performs substantive testing of the Firm’s financial statements. In the 2007 “Report of Independent Registered Public Accounting Firm”, Ernst and Young LLP issued an opinion that the financial statements of Lehman Brothers Holdings Inc. (the “Firm”) present fairly, in all material respects the consolidated financial positions of the Firm at November 30, 2007. In their report dated January 28, 2008 they expressed an unqualified opinion thereon.

## Remaining Points #3 and 6

---

### ◆ Point #3

- Matthew stated that “the Firm has tens of billions of dollar[s] of inventory that it probably cannot buy or sell in any recognized market, at the currently recorded and current market values, particularly when dealing in assets of this nature in the volume and size as the positions the Firm holds.”
- Valuation controls were not a part of Matthew’s area of responsibility in the Firm. When questioned on this opinion, he stated that only we needed to talk to Gerry Reilly, the Firm’s Capital Markets Product Controller.
- There are extensive valuation controls in the Firm along with internal and external audit testing of those controls and valuations. Corporate Audit, Ernst & Young and senior management of the Firm are comfortable with the adequacy of those controls and the financial statement disclosures around the less liquid assets.
- Gerry Reilly is presenting a review of valuation controls to the Audit Committee during this meeting.

### ◆ Point #6

- Matthew stated that “based on [his] personal observations over the past years, certain senior level internal audit personnel do not have the professional expertise to properly exercise the internal audit functions...”
- When questioned on this point by Chris O’Meara, Joe Polizzotto and Ernst & Young, he noted the following opinions:
  - In 1998, when she was the Equity Product Controller, Beth Rudofker did not adequately follow-up on a specific legal entity balance that Matthew brought to her attention.
  - Senior Corporate Management may not be independent enough.
  - Corporate Audit does evaluate controls effectively, find appropriate issues and report them to management
- Corporate Audit management recognizes that Matthew is very limited in his exposure and experience with the Corporate Audit senior management team and processes. He is not familiar with the extent of control reviews and testing the group conducts, the extent of reliance placed on the group by regulators and external auditors and the independent review of the groups processes that regulators have conducted over the years. Matthew’s opinions have never been expressed by any of these or other groups that have interacted with Corporate Audit.

# Appendices

---

- ◆ Balance Sheet and Other Financial Statement Controls Testing
- ◆ Audit Recommendations
- ◆ Balance Sheet Substantiation Details

# Balance Sheet Controls Testing

---

- ◆ Corporate Audit reviews balance sheet controls at three levels as part of annual Sarbanes-Oxley and risk based cycle audits: the consolidated financial statement level, the product level and the Firm level.
  
- ◆ **Consolidated Financial Statement Level**
  - Materiality approach, in consideration of PCAOB guidance, leads to the identification of significant accounts at the financial statement level with a further drill down to the account or disclosure component level.
  - This approach leads to the identification of financial statement lines subject to audit review and will result in the coverage of at least 70% of the financial statement line balance, on a sample basis.
  
- ◆ **Product Level**
  - An annual assessment is performed to determine which businesses have a material impact on the Firm’s financial condition. This assessment includes both quantitative and qualitative criteria.
  - For material products, a “front-to-back” audit of the controls is conducted including trade capture, middle office reconciliations, P&L, price verification, and model validation.
  
- ◆ **Firm Level**
  - Processes performed by a utility function to support all business activity across a function, for example, settlements and margin.

# Balance Sheet Controls Testing

---

- ◆ In an effort to establish a priority of business areas and processes to be covered annually, Audit evaluates each business area and process using both quantitative and qualitative factors.
  
- ◆ Quantitative criteria
  - Businesses/processes/applications that contribute more than 2% of income before taxes for the full prior year or the period to date are considered material.
  - Businesses or activities that contribute more than 2% of total assets as of the prior fiscal year-end or the period to date are considered material.
  
- ◆ Qualitative criteria
  - For each business process or activity various factors are considered including the degree of automation or manual controls, complexity of business, track record, prior audit results, regulatory oversight, staffing changes and fraud susceptibility.
  
- ◆ Control Related Documentation
  - Audit Documentation
    - Sarbanes Oxley Mapping Memo
    - Internal Control Evaluation Template
    - Walkthrough Narratives and Flowcharts
    - Audit Reports and Testing Recommendations
    - Action Plan Follow-up
  - Business Documentation
    - Policies and Procedures
    - Supporting Evidence of Controls

# Balance Sheet Controls Testing

---

- ◆ For the consolidated financial statement level testing approach and coverage, the following balance sheet financial statement lines are considered:

## **Assets**

- Cash and Cash Equivalents
- Cash and Securities Segregated
- Inventory and Financing
- Receivables
  - Broker Dealer
  - Customer
  - Other
- Property, Equipment and L/H
- Deferred Expense & Other Assets
- Goodwill

## **Liabilities**

- Commercial Paper and Short Term Debt
- Payables
  - Broker Dealer
  - Customer
- Other Liabilities
- Senior Debt
- Sub Debt

# Balance Sheet Controls - Cash

---

## **Cash and Cash Equivalents**

- ◆ Comprised mainly of interest bearing and non-interest bearing cash.
- ◆ Audit work across areas such as Operations Control – Balancing, Global Cash and Collateral Management, Regulatory Reporting and Commodity Accounting.
- ◆ Primary Controls
  - Completeness of account population
  - Reconciliation of “real world” bank accounts to sub-ledgers
  - Reporting, resolution and documentation of exceptions and clearing of breaks
  - Technology controls over the completeness of feeds into GSSR (reconciliation tool)

## **Cash and Securities Segregated**

- ◆ Comprised mainly of cash and securities segregated for the benefit of customers.
- ◆ Audit work across areas such as Operations Control – Balancing, Operations – Futures Operations, FSCP Regulated Entities, Regulatory Reporting and Commodity Accounting.
- ◆ Primary Controls
  - Accuracy and completeness of segregation calculations
  - Reconciliation of “real world” bank accounts to sub-ledgers
  - Reporting, resolution and documentation of exceptions and clearing of breaks
  - Technology controls over the completeness of feeds into GSSR (reconciliation tool)

# Balance Sheet Controls - Long/Short Inventory and Financing

---

- ◆ Includes both cash and derivatives positions, as well as financing activities.
  
- ◆ Audit work across multiple areas including Global Balance Sheet and Legal Entity Accounting – Inventory, Commodity Accounting, Operations - P&L Close, Operations Control – Balancing, Financial Statement Close Process across numerous European entities including regulated entities, Real Estate, Mortgage Origination and Bankhaus.
  
- ◆ Primary Controls include procedures to validate the accuracy and completeness of the balances in the general ledger.
  - Reviewed month-end close processes for inventory, derivatives, and financing positions from the sub-ledger (i.e. MTS, ITS TMS, Loan IQ, GEDS, and PALS) to the general ledger for various legal entities,
  - Validated manual adjustments booked by LECs/PCs
  - Sampled gross-up and net-down adjustments posted by GFS to the GL
  - Reviewed GFS logic for financing and cusip netdowns
  - Validated Intercompany derivative reconciliation process and elimination process
  - Reviewed P&L month-end close processes for MTS, ITS and TMS to the general ledger and reviewed physical stock reconciliation.

# Balance Sheet Controls - Long-term and Short-term Debt

---

- ◆ Treasury manages the activity that rolls into both short-term and long-term debt lines on the financial statements.
  
- ◆ Audit work across Global Treasury including Global Interest Control.
  
- ◆ Primary Controls
  - Procedures over short-term and long-term debt issuance processes, including trade authorization, trade capture and reconciliation, and key controls over core processing functions
  - Month-end reconciliations and processes, including FAS 133/159 calculation and debt extinguishment processes
  - Information provided to External Reporting as part of the Firm's quarterly and annual financial statement reporting process

# Balance Sheet Controls – Product Level

---

- ◆ Product Level Controls are tested across 7 categories:
  - Trade Authorizations
    - are trades properly authorized and recorded on an accurate and timely basis
  - Position Reconciliations (FO to BO) and /or estimate to actual P&L
    - is trading activity accurately and completely fed to downstream systems for clearance, settlement, confirmation and P&L reporting
  - Daily P/L preparation and explanatory process
    - accuracy of the daily and monthly P&L reports
  - Substantiation of footnotes/reserves/significant adjustments
    - documentation and propriety of adjustments to the firm's P&L
  - Quest to DBS reconciliation
    - validate inventory balances captured in the Firm's G/L at month end are complete and accurate by reconciling P&L balances in DBS back to the daily P&L reporting systems
  - Deferral/timing accounts
    - researching, documentation and clearance of differences between P&L and DBS
  - Independent Price Verification
    - validation of the valuation of the items in the Inventory Long / Short account, including cash and derivatives.

# Audit Coverage of Other Financial Statement Controls

---

## ◆ Consolidated Income Statement

- Controls over the production of the consolidated income statement and the condensed consolidating statement of income, segment reporting, G-Quest to DBS reconciliation controls, as well as controls over late P&L entries. Covered in the **Revenues and P&L Reporting** review.

## ◆ Consolidated Statement of Changes in Stockholder's Equity

- Controls over the production and roll-forward of stockholder's equity, grants and issuances, stock dividends, options exercised and treasury stock. Covered in the **Global Balance Sheet and Legal Entity Accounting – Stockholder's Equity** review.

## ◆ Consolidated Statement of Cash Flows

- Controls over the production of the consolidated statements of cash flows are documented and tested in the **External Reporting – Financial Statements and Footnotes** review.

## ◆ Footnotes

- Controls over the compilation of footnote disclosures are documented and tested in the **External Reporting – Financial Statements and Footnotes** review.

# Audit Recommendations – Infrastructure Previously Reported

---

## Front Office

- ◆ P&L deferrals and adjustments – Address accountability and resolve infrastructure causes
- ◆ Inventory pricing – Use approved models, consistent market data, focus on level III
- ◆ *Collateral pricing – Ensure ownership, consistency and accuracy*
- ◆ *Client valuations – Ensure consistency in adhering to Firm’s policy*

## Product Control

- ◆ Deferrals – Resolve unexplained deferrals on a timely basis and adjust the daily flash for differences
- ◆ P&L Adjustments – Document and management review of adjustments per policy
- ◆ Valuation – Ensure completeness and accuracy of price testing coverage, less liquid assets
- ◆ *Daily P&L estimate – Eliminate reliance on trader spreadsheets and manual controls*
- ◆ *CSE/Basel II – Consistently complete daily risk reconciliation and clean P&L requirements*
- ◆ *Daily Balance Sheet – Shift Product Control ownership and improve accuracy and automation*

## Financial Control

- ◆ Legal Entity Controls – Improve balance sheet validation secondary controls
- ◆ Regulatory Reporting – Automate CSE capital reporting process

# Audit Recommendations - Balance Sheet Substantiation

---

## ◆ **Mandate**

- Senior management reinforcement of requirements to balance sheet account owners
- Clarify responsibilities and accountability of central review group (e.g., not acceptable to reject supporting documentation if they don't understand it, need to follow-up and get resolution)

## ◆ **Definitions and Standards**

- What is required for substantiation
- Agree thresholds
- What is included or removed (e.g., intercompany accounts)

## ◆ **Resources**

- Where are resources needed in upstream groups to produce appropriate support
- What expertise is required in central review group and where should they be located

## ◆ **Technology**

- Enhancements to LEMAP tool

# Balance Sheet Substantiation Details – “Unsubstantiated”

- ◆ The original “Unsubstantiated summary provided by Matthew is shown below
- ◆ During review conversations with Matthew, he indicated:
  - Taxes were “probably o.k.”. The tax department did not turn in their back-up
  - Intercompany (I/C) balances were lower risk since they eliminate at the consolidation level. They are included in the substantiation process as that was part of the original process agreement.
- ◆ Corporate Audit testing shows:
  - That RSUs also eliminate at the consolidation level
  - Deferrals and timing adjustment findings that have been reported to management and the Audit Committee
- ◆ Details of the back-up obtained during the audit review and mapped to controls are shown on the next 2 pages

	Americas			Europe			Asia			Total		
	Debit\$	Credit\$	ABSS	Debit\$	Credit\$	ABSS	Debit\$	Credit\$	ABSS	Debit\$	Credit\$	ABSS
RSUs	704,431	(393,798,527)	394,502,556	155	(830,311,275)	830,311,431	2,576,000	(169,605,024)	169,607,601	707,162	(1,393,714,826)	1,394,421,956
TAXES	34,781,235	(10,250,389)	45,031,625	458,289,917	(206,664,161)	664,954,078	17,858,166	(16,164,937)	31,623,124	510,929,338	(233,079,487)	744,008,827
DEFERRALS	7,280,467	(7,659,026)	14,939,495	3,912,875	(1,656,587)	5,569,462		(5,634,993)	5,634,993	11,193,342	(14,950,608)	26,143,950
TIMING	10,029,210	(10,627,786)	20,656,997	106,484,839	(48,470,240)	154,955,080	5,488,565	(15,388,398.80)	20,876,963	122,002,614	(74,486,424)	196,489,040
I/C RECEIVABLE	3,243,434	(506,431)	4,049,865	6,392,753,012	(115,793,127)	6,508,556,139				6,396,006,446	(116,599,556)	6,512,606,005
I/C PAYABLE		(6,027,045)	6,027,045	115,793,127	(5,847,740,792)	5,963,533,919		(75,796,407)	75,796,407	115,793,127	(5,929,564,244)	6,045,357,371
OTHER	1,453,210,451	(508,771,773)	1,961,982,224	9,574,670,356	(7,644,443,974)	17,218,514,368	1,190,345,954	(158,744,976)	1,349,090,928	12,217,626,801	(8,311,960,723)	20,529,587,517
<b>TOTAL</b>	<b>1,509,249,228</b>	<b>(937,940,979)</b>	<b>2,447,190,207</b>	<b>16,651,314,321</b>	<b>(14,695,080,156)</b>	<b>31,346,394,477</b>	<b>1,213,695,281</b>	<b>(441,334,735)</b>	<b>1,655,030,016</b>	<b>19,374,258,830</b>	<b>(16,074,355,870)</b>	<b>35,448,614,700</b>
											Less doubled counted in "rejected"	(807,878,404)
												<b>34,640,736,296</b>
<sup>1</sup> LE 0C18 Townsend Analytics \$203m were not substantiated for Q1, primarily due to Technology related issues.												
<sup>2</sup> LE 0056 LBL has had a number of Statutory Reporting priorities (per Raymond O'Grady email on 5/1), which contributed to \$3.5bn unsubstantiated for Q1.												
<sup>3</sup> LE 0913 LBIE Madrid with \$32m unsubstantiated for Q1, are currently formalizing efficient reconciliations for accounts requiring substantiation and estimate to be more effective by Q3.												

# Balance Sheet Substantiation Details – “Unsubstantiated”

Audit Review Detail  
 “Unsubstantiated Balance”  
 As of February Month-End 2008

	Balance	ABS	
<b>Original Balance</b>	<b>2,537,124,518</b>	<b>34,640,736,296</b>	
<b>Auto Intercompany Eliminations</b>			
Financing	395,950,884	395,950,884	
Inv	(134,752,084)	1,727,827,098	
LTD	(5,028,054,692)	5,028,054,692	
Other Assets	5,318,504,752	5,320,117,615	
Other Liab	(86,013,089)	86,013,089	
<b>Subtotal I/C</b>	<b>465,635,772</b>	<b>12,557,963,377</b>	
<b>Manua I/C Eliminations</b>			
FOREIGN GOVTS	2,983,625.39	2,983,625.39	
Min Interest	(968,844.24)	456,806,861.32	
	<u>2,014,781.15</u>	<u>459,790,486.71</u>	
<b>RSU Accounts - Offset</b>	<b>(1,384,835,486)</b>	<b>1,386,249,812</b>	The 23010 account is used similar to a "bridge" account to allocate stock-based compensation expenses to each legal entity. The offsetting balance is on LBHI. When consolidated, these balances net to zero.
<b>Original Balance Less I/C eliminations &amp; RSU Accounts</b>	<b><u>3,454,309,451</u></b>	<b><u>20,236,732,619</u></b>	
<b>Additional Support Obtained by Corporate Audit</b>			
Cash & Cash Eq - WOOD STREET INVESTMENTS LTD	293,006,283	293,006,283	Received deposit summary from Front Office, which is reconciled to DBS by FC
CW Lease Payable	(1,369,296,359)	1,369,296,359	Obtained Rec from FC for Feb
LTD ADJ FAS133 HEDGING CO 59	(22,918,765)	22,918,765	Tested in Feb as part of Treasury SOX testing
PENSION CLEARING PREPAYMENT	113,689,424	113,689,424	Received pension actuary report from FC
Other Assets - Fixed Assets	306,585,342	848,257,032	Received FA rollover schedule; PS FA to GL Rec; Tested purchases and retirements
Other Liab - Bonus Accrual Process	(129,923,141)	129,923,141	Received reconciliation from LEC
Other Rec - Other (Co 0B42 - Advisory Fees)	74,907,649	74,907,649	Received PS GL to GL Rec from IMD; IMD Audit tested the process from Advantage billing to PS GL
FAS 140 Gross Up for ELQ (Co 00S1)		1,045,406,422.38	Received reconciliation from LEC
Inv - Cash Long			
Asia: HERCULES KK - FOREIGN CORPORATE LOANS	891,722,444	891,722,444	LEC Inventory Reconciliation received
Asia: HERCULES KK - OTHER BONDS & OBLIG FOREIGN	(69,272,583)	69,272,583	LEC Inventory Reconciliation received
Foreign Corporate Loans - Yellow	129,885,872	129,885,872	Loan IQ and Quest Adj journals received
Loan Portfolio - Turkish AMC	93,977,345	93,977,345	Loan summary received from servicer.
Capstone Entities			
Inv - Cash Long	4,697,551,958	4,697,551,958	Received reconciliation from LEC
Financing - Secured Financing Short	(2,848,483,363)	2,848,483,363	Received reconciliation from LEC
Cash & Cash Eq	105,663,287.48	105,663,287.48	Europe provided rec for Cash GIC-Other & Collect Bank Acct
Other Assets - Tax	180,985,850	181,390,829	Tax reconciles these balances - received 1st Qtr binder
Other Liab - Tax	77,151,810	515,320,319	Tax reconciles these balances - received 1st Qtr binder
Other Assets - Goodwill & Intangibles (0C18)	15,880,395	15,880,395	Agreed balance to Purchase Price Allocation Memo for TAL
Other Assets - Goodwill (Co 0C18)	48,458,095	48,458,095	Rec from LEC
Other Assets - Goodwill (Co 0A97)	137,632,159	137,632,159	Received reconciliation from LEC
Other Liab - Accrued liabilities & Other (00E2 & 00F7)	(1)	28,192,770	Unsubstantiated balances in account net across entities
Suspense Liabilities - Gainsborough & Kenilworth	286,356,757	286,356,757	DBS drilldown shows offset of 01M4 and 01M5 on 01M6
Cash & Cash Equivalents - Canada	12,366,586	12,366,586	Subledger to GL rec provided by LEC; subledger to bank account rec requested from Ops Control
Bonus Accrual & Payment	(8,648,986.93)	1,372,148,689.17	Reconciliation between DBS and supporting schedule obtained from Payroll. Tested for 2007 by LDN audit
	<u>3,017,278,058</u>	<u>15,331,708,527</u>	
<b>Support Obtained by Finance Control</b>			
Thayer Min Int	(137,996,833)	137,996,833	

LBEX-AM 067689

# Balance Sheet Substantiation Details – “Unsubstantiated”

Audit Review Detail  
 “Unsubstantiated Balance” (continued)  
 As of February Month-End 2008

	Balance	ABS	
<b>Covered by Process Controls Tested by Audit</b>			
<b>NY</b>			
Deferred Compensation	(6,566,024.91)	10,823,700.75	Compensation Control
GL Suspense Account	3,352,236.09	3,352,236.09	GL Admin
Software Accruals	(3,943,655.70)	3,943,655.70	ITD Expense Control
Cash & Cash Equivalents	5,139,789.04	17,340,488.74	Operations Control, on a sample basis controls were tested
Inv - Derivatives Timing and deferrals	47,516,189	196,489,041	SOX 2007, on a sample basis controls were tested
Inv - P&L Deferrals	(3,757,267)	26,143,952	SOX 2007, on a sample basis controls were tested
Inv - Derivatives MTM Adjustments	7,349,403	35,008,143	SOX 2007, on a sample basis controls were tested
<b>London</b>			
Cash & Cash Equivalents	(75,651,308)	134,117,146	
Inventory - Financing	(84,497,762)	84,497,762	
Inventory - Cash	17,222,542	119,594,663	
Inventory - Derivatives	(4,253,758)	4,253,758	
Mortgage Related - Europe	442,479,588	1,621,751,058	SOX 2007, on a sample basis controls were tested
Mortgage Related - Europe (ELQ)	(741,667)	48,909,959	2008 extended scope for ELQ entity, on a sample basis controls were tested
Other Assets	30,000,628	33,147,293	
Other Liab	(420,309,668)	531,606,160	
Other Rec	61,957,012.57	67,215,002.93	
<b>Tokyo</b>			
Cash & Cash Equivalents	52,448,008	52,448,008	Cash Management
Inventory - Financing	41,790,545	41,818,004	Financial Statement Close & LEC
Inventory - Cash	80,726,001	99,290,218	Financial Statement Close & LEC
Inventory - Derivatives	51,935,145	56,420,748	Financial Statement Close & LEC
Other Assets	(331,542)	4,846,871	Financial Statement Close & LEC
Other Liab	(39,968,412)	45,855,613	Expense Close & Accounts Payable
Other Liab - Pay to B/D	(6,782,134)	7,821,736	Financial Statement Close & LEC
Other Rec	38,264,817	43,491,585	Financial Statement Close & LEC
	<u>233,378,704</u>	<u>3,290,186,801</u>	
<b>Total Additional Support &amp; Mapped</b>	<u>3,112,659,929</u>	<u>18,759,892,162</u>	
<b>Remaining Balance to be mapped</b>	<u>341,649,522</u>	<u>1,476,840,457</u>	
<b>Total Assets (after eliminations and net-downs)</b>	<b>786,085,000,000</b>	<b>786,085,000,000</b>	
<b>% to be mapped</b>	<b>0.04%</b>	<b>0.19%</b>	

# Balance Sheet Substantiation Details – “Exceptions”

- ◆ The original summary of balances that were substantiated with exceptions that were being followed up on by management is shown below
- ◆ Corporate Audit conducted a sample review of these items as shown on the next page

	Americas			Europe			Asia			Total		
	Debits	Credits	ABSS	Debits	Credits	ABSS	Debits	Credits	ABSS	Debits	Credits	ABSS
RSUs	1,708,656,365	(35,047,127)	1,743,703,193	16,259	(4,746,931)	4,763,191		(26,945,299)	26,945,299	1,708,672,324	(66,739,357)	1,775,411,663
TAXES	2,837,706	(92,388,114)	95,225,820	11,198,016	(2,849,984)	14,048,001	6,731,826	(4,346,882)	11,078,709	20,767,548	(99,564,950)	120,352,530
DEFERRALS	211,864,869	(83,326,370)	295,191,239	515,399,348	(215,581,829)	730,981,178	60,976,852	(84,511,479)	145,488,332	788,241,069	(383,419,678)	1,171,660,749
TIMING	184,329,640	(125,416,802)	309,746,442	1,954,272	(18,791,881)	20,746,155	882,416		882,416	187,166,328	(144,208,683)	331,375,013
I/C RECEIVABLE	2,031,321,055	(826,596,439)	5,514,692,312	46,723,079	(9,383,588)	56,106,667	81,448,533	15,539,619	99,988,153	2,159,492,667	(817,440,408)	5,670,787,132
I/C PAYABLE	447,080 <sup>1</sup>	(692,441,548)	692,688,626	18,415,400	(56,525,240)	74,940,641		(127,306,328)	127,306,328	18,862,480	(876,273,116)	865,135,597
OTHER	1,086,903,585	(1,333,204,715)	2,420,105,298 <sup>1</sup>	631,087,511	(502,173,722)	1,133,261,227 <sup>2</sup>	3,880,541,625	(384,160,036)	4,227,622,620 <sup>3,4</sup>	5,598,532,921	(2,219,538,473)	7,780,992,145
<b>TOTAL</b>	<b>5,226,360,000</b>	<b>(3,188,421,115)</b>	<b>11,071,555,932</b>	<b>1,224,793,885</b>	<b>(810,053,175)</b>	<b>2,034,847,060</b>	<b>4,030,581,452</b>	<b>(608,730,405)</b>	<b>4,639,311,857</b>	<b>10,481,735,337</b>	<b>(4,607,204,695)</b>	<b>17,745,714,849</b>
<sup>1</sup> \$1.2bn relates to LBHI items which were subsequently resolved.												
<sup>2</sup> \$75.7m relates to exceptions categorized as "misclassifications".												
<sup>3</sup> \$1.2bn relates Mauritius legal entities which were subsequently resolved.												
<sup>4</sup> \$1.6bn in exceptions reflected was an error and actual amount should have been \$1.6m, and this occurred in LE 067C - Milford YK.												

# Balance Sheet Substantiation Details – “Exceptions”

Audit Review Detail  
 “Exceptions” Review  
 As of February Month-End 2008

	<u>Exception Amount (USD)</u>	<u>ABS Except Amount (USD)</u>	
Original Balance	8,531,305,459	17,746,398,070	
<b>Intercompany Eliminations</b>			
Financing	(462,797,055)	537,245,005	
Inv	2,420,666,441	3,347,698,139	
LTD	(592,033,467)	595,220,951	
Other Assets	1,839,636,415	1,853,267,953	
Other Liab	(164,759,813)	165,678,520	
<i>Subtotal I/C</i>	<u>3,040,712,521</u>	<u>6,499,110,568</u>	
RSU Accounts - Offset	1,650,163,171	1,767,181,478	
<b>Original Balance Less I/C eliminations &amp; RSU Accounts</b>	<u><u>3,840,429,768</u></u>	<u><u>9,480,106,023</u></u>	
<b>Additional Support Obtained</b>			
Other Assets - Fixed Assets	61,148,541	73,391,854	Received FA rollforward schedule: PS FA to GL Rec; Tested purchases and retirements
Other Assets - Tax	(627,132)	644,185	Tax reconciles these balances - received 1st Qtr binder
Other Liab - Tax	(85,204,538)	106,834,860	Tax reconciles these balances - received 1st Qtr binder
	<u>(24,683,129)</u>	<u>180,870,899</u>	
<b>Pending Additional Support</b>			
ASIA	3,013,021,139	3,353,954,364	
Americas	(41,980,886)	1,262,053,497	
	<u>2,971,040,253</u>	<u>4,616,007,861</u>	
<b>Covered by Process Controls Tested by Audit</b>			
Inv - Derivatives Timing and deferrals	49,059,515	325,003,561	
Inv - P&L Deferrals	404,821,390	1,171,660,749	
Inv - Derivatives MTM Adjustments	(5,671,292)	64,670,808	
	<u>448,209,613</u>	<u>1,561,335,118</u>	
<b>Total Additional Support</b>	<u><u>3,394,566,738</u></u>	<u><u>6,358,213,878</u></u>	
<b>Remaining Balance to be mapped</b>	<u><u>445,863,030</u></u>	<u><u>3,121,892,145</u></u>	
<b>Total Assets (after eliminations and net-downs)</b>	786,085,000,000	786,085,000,000	
<b>% to be mapped</b>	0.1%	0.4%	

# Balance Sheet Substantiation Details – “Rejected”

◆ Corporate Audit also conducted a sample review of the rejected balances as shown below

Audit Review Detail  
"Rejected" Balance  
As of February Month-End 2008

	Balance	ABS	
Original Balance	2,136,620,347	31,353,481,163	
<b>Intercompany Eliminations</b>			
Inv	(575,799,018)	725,334,897	
LTD	(447,070,769)	447,070,769	
Other Assets	535,348,444	535,348,444	
Other Liab	(57,933,253)	90,642,286	
<b>Subtotal I/C</b>	<b>(545,454,596)</b>	<b>1,798,396,395</b>	
<b>Original Balance Less I/C eliminations</b>	<b>2,682,074,943</b>	<b>29,555,084,768</b>	
<b>Additional Support Obtained</b>			
CASH & SECURITIES SEGR	759,362,807	759,362,807	Obtained Commodity Accounting/Ops Rec for Feb
01P9 - Financing - Secured Financing Short	(2,253,022,070)	2,253,022,070	Manually eliminated in cons - support was attached to LEMAP
00N3 FAS 140 Gross Up	881,934,630	3,279,299,355	FAS140 Gross Up file received
01G2 Inventory Cash - Long	176,208,465	176,208,465	LoanIQ and GFS downloads provided
00S1 Inventory Cash - Long	885,711,418.95	885,711,418.95	Entity's trial balance received from Coda (00S1's GL) denoting loan amounts. Loan # total agrees to DBS
Other Assets - Fixed Assets	368,848,371	768,330,738	Received FA rolloffward schedule; PS FA to GL Rec: Tested purchases and retirements
Other Assets - Tax	34,990,514	34,990,514	Tax reconciles these balances - received 1st Qtr binder
Other Liab - Tax	(250,259,429)	444,413,041	Tax reconciles these balances - received 1st Qtr binder
Inventory Cash - Asia	(3,411,501,883)	5,351,629,148	Support obtained by Tokyo audit
Financing - Asia	941,777,874	941,777,874	Support obtained by Tokyo audit
	<b>(1,865,949,301)</b>	<b>14,894,745,432</b>	
<b>Covered by Process Controls Tested by Audit</b>			
NY - Inv - Derivatives Timing and deferrals	43,265,778	247,957,761	
NY - Inv - P&L Deferrals	(28,018,039)	38,740,166	
NY - Inv - Derivatives MTM Adjustments	27,430,910	28,332,532	
Asia - Cash Management	353,265,130	353,265,130	
Asia - Financial Statement Close & LEC	4,381,872,864	7,912,450,947	
Asia - Expense Close & Accounts Payable	(577,425,393)	610,401,408	
LDN Tested	(54,731,318)	2,191,587,645	
	<b>4,145,659,933</b>	<b>11,382,735,588</b>	
<b>Total Additional Support</b>	<b>2,279,710,632</b>	<b>26,277,481,020</b>	
<b>Remaining Balance to be mapped</b>	<b>402,364,311</b>	<b>3,277,603,747</b>	
<b>Total Assets (after eliminations and net-downs)</b>	<b>786,085,000,000</b>	<b>786,085,000,000</b>	
<b>% to be mapped</b>	<b>0.1%</b>	<b>0.4%</b>	