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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15168

In the Matter of	:
JOHN J. AESOPH, CPA, and	:
DARREN M. BENNETT, CPA	:
Respondents.	:

RESPONDENT JOHN J. AESOPH'S PETITION FOR COMMISSION REVIEW OF INITIAL DECISION

August 11, 2014

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Respondent John J. Aesoph, through his attorneys of record and pursuant to Rule 410 of the Securities and Exchange Commission's Rules of Practice, respectfully petitions the Commission to review the Initial Decision dated June 27, 2014, dismiss the charges against him, and set aside the sanction ordered by the Administrative Law Judge ("ALJ"). In support of this Petition, Mr. Aesoph states as follows.

I. INTRODUCTION

Through this Petition, Mr. Aesoph asks the Commission to review an Initial Decision that erroneously interprets accounting and audit guidance relating to fair value estimates and loan loss allowances—including guidance released at the height of the 2008 financial crisis—and fails to adequately consider and weigh the record evidence. The Division's case and the Initial Decision focus on the procedures that Mr. Aesoph and his KPMG LLP audit team performed on the year-end 2008 financial statements and internal controls of TierOne Corporation ("TierOne" or "Bank"). Specifically, the Initial Decision levels a sanction against Mr. Aesoph—an unwarranted sanction, as explained in this Petition—for his work on that portion of TierOne's allowance for loan and lease losses ("ALLL") that was governed by Statement of Financial Accounting Standards Nos. 114, Accounting by Creditors for Impairment of a Loan ("FAS 114"), and FAS 157, Fair Value Measurements ("FAS 157").

At base, the Initial Decision is fundamentally flawed because it fails to demonstrate consideration or weighing of the evidence admitted at a nine day trial; indeed, it is as if no hearing ever occurred. The ALJ set entirely aside testimony from both the Division and Respondents' audit and accounting experts, erroneously interpreted the professional standards, improperly applied the audit documentation standard as an exclusionary rule of evidence limiting her consideration of evidence, and then substituted her own judgment as to what a "reasonable

auditor" would have done under the circumstances. As a result, the Initial Decision suffers from serious and clear procedural, factual and legal errors that implicate important accounting and audit policies and standards.

As outlined below, this failure to weigh the evidence is critical for several reasons, not the least of which is the fact that the Division's own accounting expert, when confronted with the audit evidence gathered and assessed by Mr. Aesoph and his team, agreed with Mr. Aesoph and Sandra Johnigan, Respondents' expert and a member of the Auditing Standards Board of the AICPA, on critical points.

Rather than address the applicable guidance, the Initial Decision ignores the fair value accounting standards and releases issued by the Financial Accounting Standards Board and the SEC Office of the Chief Accountant in October 2008—the very year of the challenged audit—finding that the audit work should have reflected consideration of "market price" and "current appraisals." However, the fair value standards explicitly reject sole reliance on market price in a disorderly market as evidence of fair value, and the Initial Decision appeared to ignore the appraisals and other audit evidence Mr. Aesoph and his team actually obtained. The Initial Decision faults Mr. Aesoph and his team for not reaching conclusions on individual loans when the professional standards impose no such obligation. It misconstrues the auditor's obligation with regard to auditing internal controls over financial reporting, focusing on a single procedure rather than the controls relevant to the financial statement assertion. And it fails entirely to weigh evidence relating to Mr. Aesoph's conduct on each of these and other points, asserting instead in boilerplate language that "[a]ll arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision were considered and rejected." These and other errors, left unaddressed and uncorrected, amount to a denial of Respondent's due process rights.

A. The Significance of FAS 114 and the Estimate of Fair Value

FAS 114 required TierOne to individually evaluate a subset of its real estate loans to determine whether they were impaired (i.e., whether it was "probable" that TierOne would not collect all payments according to the terms of the loan agreement). If a loan was impaired, TierOne measured the probable loss by estimating the fair value of the loan's real estate collateral.

Under Generally Accepted Accounting Principles ("GAAP")—including 2008 guidance from the Commission's Office of the Chief Accountant—TierOne could not use an off-the-shelf formula or rely on a single data point such as a real estate appraisal to make its fair value estimates for the collateral securing impaired loans. This was especially true during the unprecedented market upheaval brought on by the financial crisis of 2008. Instead, under FAS 157, TierOne was required to exclude from its fair value analysis any market prices or data tainted by distressed sales and instead employ its "own assumption[s] about the assumptions that market participants would use"—known as "Level 3 inputs." Because foreclosures and other forced sales dominated many of TierOne's lending markets in the second half of 2008, it is impossible to understand TierOne's accounting or Mr. Aesoph's year-end 2008 audit without understanding the nuances of FAS 157 and related guidance. The Initial Decision faults Mr. Aesoph for relying on undiscounted appraisals from the first two quarters of 2008 despite "contrary market information" at year-end. Initial Dec. at 36. But that is the very point the Initial Decision fails to grasp: declines in foreclosure and forced sale prices in the latter half of 2008 are not—according to FAS 157 and the Staff's own 2008 guidance—indicative of fair value at year-end. Thus, the "contrary market information" to which the Initial Decision alludes would not cause a reasonable auditor to doubt the reasonableness of the year-end collateral fair value estimates.

Mr. Aesoph and his audit team were keenly aware of this guidance. Mr. Aesoph himself gave a presentation to TierOne's Audit Committee regarding the implementation of FAS 157 in 2008, the year FAS 157 first became effective. (J.P.F. ¶ 119[1]; Resp'ts Ex. 1, Work Paper A-5.2, KPMGTO 2416.) Additionally, he and Respondent Darren Bennett reviewed and commented on the FAS 157 disclosure included in TierOne's 2008 Form 10-K, a disclosure critically important to understanding the Bank's estimate of impaired loan losses. (J.P.F. ¶ 118–119.) The Bank disclosed that, in estimating these losses, it relied not only on "external appraisals" but also "assessment of property values by our internal staff." (J.P.F. ¶ 118 (Resp'ts Ex. 1E, TierOne 2008 10-K, KPMGTO 2214–19).) It further explained that "[b]ecause many of these inputs are not observable, the measurements are classified as Level 3." (*Id.*) That is, TierOne's FAS 114 loss estimates were, of necessity, based on the least precise evidence recognized by the accounting standards.

In light of the market turmoil of 2008 and the effect of those market conditions on the Bank's fair value estimates and resultant FAS 114 loan losses, Mr. Aesoph and his team determined that the Bank's ALLL required close attention. As a result, during the year-end 2008 audit they performed expanded procedures directed toward TierOne's FAS 114 accounting and related internal controls. Despite no requirement that an auditor opine as to the reasonableness of the estimated collateral values supporting each loan, the auditors ultimately reviewed *every one* of TierOne's "FAS 114 templates," the documents the Bank prepared to estimate losses on individual impaired loans. Indeed, one remarkable aspect of the Initial Decision is that it finds

[1] Citations to "J.P.F." refer to the Joint Proposed Findings of Fact and Conclusions of Law that Mr. Aesoph and Respondent Darren Bennett filed on December 10, 2013. Citations to "Resp'ts Ex." refer to Respondents' Joint Exhibits admitted at trial. Citations to "Div. Ex." Refer to Division's Exhibits admitted at trial. Citations to "Tr." refer to pages of the trial transcript, with witnesses indicated in parentheses.

Mr. Aesoph violated the heightened negligence standards of Commission Rule of Practice 102(e) despite the acknowledged, and undisputable, fact that TierOne's ALLL in general, and the FAS 114 portion in particular, was a focus of the audit and was the subject of a multitude of audit procedures.

B. The ALJ's Two Principal Errors – Each of Which Requires Commission Review

The ALJ, in sanctioning Mr. Aesoph despite his exercise of due care over TierOne's ALLL, made two principal errors. *First*, the ALJ misconstrued and misapplied the audit and accounting guidance that Mr. Aesoph and his team were bound to follow, including the critically important provisions of FAS 157 that govern fair value estimates. In doing so, the ALJ ignored the expert testimony adduced at trial. This means that the Initial Decision's interpretation and application of the professional standards, and the resulting sanction against Mr. Aesoph, were issued by an agency employee without the requisite subject matter expertise and without proper consideration of the record—a violation of the Administrative Procedure Act ("APA") and due process. *See* Section III(A), below. *Second*, the ALJ failed to consider, weigh, or reconcile much of the evidence Mr. Aesoph presented at the hearing, resulting in an Initial Decision that violates basic requirements of the APA. *See* Section III(B), below. These defects and others, *see* Sections III(D)-(F) below, all require Commission review and, ultimately, reversal of the Initial Decision.[2]

[2] Mr. Aesoph also joins in Respondent Darren M. Bennett's Petition for Review of the ALJ's Initial Decision.

II.
BACKGROUND

A. TierOne Bank

Historically, TierOne was a regional bank[3] headquartered in Lincoln, Nebraska, with operations in Nebraska, Iowa, and Kansas. During the real estate boom of the mid-2000s, the Bank opened or acquired nine loan production offices (LPOs) in various states, including Arizona, Florida, and Nevada, for the chief purpose of originating construction and land-development loans in high-yield, rapidly developing markets. By year-end 2008, TierOne had a total net loan portfolio of approximately $2.8 billion.

As is commonly known, and as reflected in the record of this proceeding, the 2008 market crash ushered in the worst economic recession in decades, led to a national wave of real estate foreclosures, and caused the failure of hundreds of banks across the country. In June 2008, recognizing the distress in the markets, TierOne centralized all servicing of loans, including loans originated and previously serviced by its LPOs, to its home office in Lincoln, Nebraska. The Bank also closed all nine of its LPOs in an effort to limit loss exposure and to refocus future lending activity to its primary market area of Nebraska, Iowa, and Kansas. In June 2010, as TierOne continued to suffer losses in the wake of the financial crisis, the FDIC took over the Bank as receiver.

B. Mr. Aesoph and the Year-End 2008 Audit

Mr. Aesoph was the partner in charge of the 2008 audit of TierOne's year-end financial statements and internal controls over financial reporting. (J.P.F. ¶ 8.) His 15-year career in the accounting profession to that date—13 of them auditing financial institutions, both public and

[3] TierOne Corporation was the holding company for TierOne Bank, a wholly owned subsidiary.

private—prepared him well for that role. (J.P.F. ¶¶ 3-7.) Moreover, Mr. Aesoph was well supported by KPMG's staff of experienced audit professionals, including Terence Kenney, the SEC Concurring Review Partner and Audit Practice Leader for the Financial Services Practice of KPMG's Chicago office; Respondent Darren Bennett, senior manager on the engagement team; Sandra Washek, a Financial Risk Management Specialist; two Financial Regulatory Specialists; David Butler, KPMG's Western Regional Professional Practice Partner; and various economic valuation and forensics experts. (J.P.F. ¶¶ 28, 37, 199-200, 440.)

Because the economic environment in 2008 had become more challenging and the accounting issues facing TierOne had grown more complex, Mr. Aesoph directed the engagement team to intensify the audit procedures performed on the TierOne engagement. (J.P.F. ¶ 180.) The change was substantial. During the 2008 audit and quarterly reviews, the team recorded a 50 percent increase in hours over 2007, with most of those increased hours dedicated to TierOne's ALLL. (*Id.*) Mr. Aesoph himself increased the hours he personally devoted to the TierOne audit in 2008 by more than 35 percent. (J.P.F. ¶ 181.) And he spent many of these hours on-site at TierOne in Lincoln, Nebraska supervising the audit, having discussions with TierOne management, and conducting his own review of the work papers and loan files. (J.P.F. ¶ 9.)

The quarterly and year-end 2008 work papers—comprising 19 binders and over 7,000 pages, all of which are now part of the record (J.P.F. ¶ 435)—reflect this carefully planned audit and set forth the significant amount of audit evidence Mr. Aesoph and his team gathered in assessing TierOne's ALLL and internal controls. Indeed, the auditors obtained and performed procedures on FAS 114 analyses for fifty-five borrower relationships, accounting for a total of 186 loans, 156 of which were impaired. This evidence did not suggest some systemic problem

with the Bank's impaired loan loss estimates, as the Division has alleged. Instead, it demonstrated to the auditors that TierOne was appropriately considering both the specific characteristics of individual loan collateral as well as market-wide information to arrive at reasonable loan loss estimates. The Bank's process for estimating fair value led to total impaired loan losses of 22% recorded in 2008—more than *one-fifth* the book value of the Bank's FAS 114 loans. (J.P.F. ¶ 402.) In Nevada, TierOne's riskiest lending market, the auditors observed TierOne record even greater losses—the bank recognized losses of nearly 30% on impaired Nevada loans during 2008, a number consistent with the 33% decline in raw market prices suggested by publicly available market indices. (J.P.F. ¶¶ 376, 402.) Indeed, compared to those indices, the 30% losses appeared conservative: the decline in the Nevada real estate market in 2008 was fueled largely by distressed sales, which under FAS 157 do not reflect fair value. (J.P.F. ¶¶ 376, 499–502.) Exhibit A to this Petition, a chart admitted at trial, illustrates this fact: while losses recorded by TierOne on its impaired Nevada loans track the decline in the Case-Shiller market index closely—an index that included distressed sales, TierOne's recorded losses even exceeded declines in an index that excludes distressed sales.

In 2010, a year after signing the audit opinion on TierOne's 2008 financial statements and internal controls, Mr. Aesoph discovered that TierOne management had concealed an internal analysis showing, on a loan-by-loan basis, a very different scope of subjectively estimated loan losses than had previously been disclosed to the KPMG audit team or to the public. (J.P.F. ¶ 449.) It later became clear that this conduct by Bank management was part of a collusive fraud that targeted the auditors themselves. (J.P.F. ¶ 450.) The Commission filed complaints against these members of management, explaining that senior Bank personnel engaged in a scheme to make "false representations" to Mr. Aesoph and his team by "falsifying"

FAS 114 documentation and "failing to inform the auditor[s] of appraisals and other valuation information that demonstrated significant declines in the collateral underlying the bank's impaired loans." (J.P.F. ¶¶ 442–43.)

There is no allegation that Mr. Aesoph or his team could have or should have discovered this concerted fraud. Thus, it is impossible to evaluate the professionalism Mr. Aesoph exercised during the 2008 audit without considering the obstructions management placed in his way. *See, e.g.*, AU § 316.12 ("[T]he characteristics of fraud . . . may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent."). Indeed, Mr. Aesoph's actions illustrate the tenacity with which he practices his chosen profession. When he became aware that Management had potentially deprived him of material information bearing on TierOne's financial statements, he relentlessly pursued the truth—repeatedly confronting Bank management. (Tr. 1752:25–58:20 (Aesoph).) On April 23, 2010, after concluding from his investigation that KPMG could no longer rely on management's representations, Mr. Aesoph informed TierOne that KPMG was immediately resigning as independent auditor, withdrawing its audit opinion on TierOne's year-end 2008 financial statements, and withdrawing its year-end 2008 internal control assessment. (J.P.F. ¶ 449.)

These actions are not the mark of an auditor deserving of sanctions under Rule 102(e).

C. The OIP, the Hearing, and the Initial Decision

The Order Instituting Proceedings ("OIP") alleged that Mr. Aesoph and his audit manager, Mr. Bennett, engaged in "improper professional conduct" under the heightened negligence standards of Rule 102(e)(1)(iv)(B). That is, the OIP alleged that Mr. Aesoph engaged in "[a] single instance of highly unreasonable conduct" or "[r]epeated instances of unreasonable

conduct" that "indicate a lack of competence to practice before the Commission." *Id.* The OIP did not allege reckless or intentional conduct.

The OIP's allegations encompass only the work that Mr. Aesoph and his team performed on TierOne's FAS 114 loan losses—they do not include the vast majority of the work Mr. Aesoph performed during the year-end 2008 audit, including ALLL-related audit procedures performed on the largest portion of the Bank's loan portfolio (approximately $2.5 billion), which was accounted for under FAS 5. The OIP asserts that Messrs. Aesoph and Bennett ignored various "red flags" in evaluating TierOne's FAS 114 accounting, did not obtain sufficient evidence regarding the Bank's individual FAS 114 loan loss estimates, and failed to identify or test an internal control that effectively addressed the bank's property-by-property loan losses. Astonishingly, however, the OIP never once mentions FAS 157, the accounting standard that defines fair value and governed the Bank's individual loan loss estimates—an omission that reflects a fundamental misunderstanding of TierOne's FAS 114 accounting, the audit procedures Mr. Aesoph planned and performed, and the audit evidence he and his team obtained. Indeed, at the hearing and in its briefing before the ALJ, the Division of Enforcement repeatedly characterized FAS 157 as a "red herring." (*See, e.g.*, Tr. 42:18–25 (Division's Counsel).)

The Division presented two experts at the hearing. Its proffered audit expert, Mr. John Barron, admitted that he ignored a substantial body of evidence that the auditors referenced in their work papers and undeniably consulted: TierOne's loan files. (J.P.F. ¶ 483.) He conceded that information in the loan files might have affected his expert opinions, had he reviewed them. (*Id.*) And when confronted with some of this information at trial, Mr. Barron disowned a statement in his expert report accusing Mr. Aesoph of failing to obtain corroborating evidence for one of TierOne's FAS 114 loan loss estimates. (J.P.F. ¶ 484.) Moreover, Mr. Barron's

opinions echoed the Division's strategy of avoiding FAS 157. Mr. Barron admitted in cross-examination that a crucial accounting issue in 2008 was the application of FAS 157 in markets increasingly dominated by distressed sales and conceded that "auditors and others were struggling with how to apply [FAS] 157 in markets where you had deteriorating conditions." (J.P.F. ¶ 480 (Tr. 1236:6–13 (Barron)).) Yet without explanation, his expert report omitted the accounting guidance directly relevant to that issue and never once mentioned that FAS 157 excludes distressed sales from the fair value analysis. His report and his testimony therefore incorrectly minimized the importance of critical provisions of GAAP and their relevance to the year-end 2008 audit.

Testimony from the Division's proffered economic expert, Professor Anjan Thakor, was equally flawed. Although, as the ALJ acknowledged, Professor Thakor is not a certified public accountant and is not qualified to opine on accounting matters, the Division attempted to use him to redefine FAS 157. (J.P.F. ¶¶ 509.) According to Professor Thakor and the Division, market prices are the determining factor in making fair value estimates, regardless of whether the market in question is dominated by distressed sales. As explained below, that view is directly contrary to FAS 157 and guidance issued by the Commission's Office of the Chief Accountant in October 2008, the year the audit was conducted.

The ALJ adopted the Division's arguments wholesale, ignoring the bulk of the evidence Mr. Aesoph presented at the hearing. For example, and as explained further below, the Initial Decision ignores the testimony of audit expert Sandra Johnigan and economic and banking expert Dr. Chris James, both of whom explained precisely how the Division's allegations contravene undisputed facts and the authoritative provisions of GAAP that were in effect when Mr. Aesoph conducted his audit.

III.
THE ALJ DECISION IS APPROPRIATE FOR COMMISSION REVIEW

The Rules of Practice provide that the Commission may review "prejudicial error[s]"; "finding[s] or conclusion[s] of material fact that [are] clearly erroneous"; "conclusion[s] of law that [are] erroneous"; and "decision[s] of law or policy that [are] important and that the Commission should review." Rule 411(b)(2). The Initial Decision commits all of these errors. Moreover the ALJ's initial decision violates due process and the Administrative Procedure Act as it is "arbitrary, capricious, an abuse of discretion, [and] otherwise not in accordance with law"; is "contrary to constitutional right"; and is "unsupported by substantial evidence." 5 U.S.C. § 706(2); *see also* 5 U.S.C. § 702 (providing right of judicial review where adversely affected by agency action). As set forth below, Mr. Aesoph takes exception to the following findings of fact and conclusions of law contained in the Initial Decision and the inferences and conclusions drawn from them.[4] For ease of reference, the challenged findings and conclusions have been organized by topical heading.

A. The ALJ Erroneously Interpreted Audit and Accounting Standards

1. The Initial Decision endorses the Division's strategy of retroactively rewriting audit and accounting standards in an attempt to support the charges against Mr. Aesoph. This violated Rule 102(e)'s prohibition on the use of hindsight to evaluate the professionalism of independent auditors. *See* Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164, 57168 (Oct. 26, 1998)(Rule 102(e) "focus[es] on the behavior of an accountant

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[4] Mr. Aesoph respectfully incorporates in this Petition the designation of any portion of the Initial Decision that materially disagrees with the Joint Proposed Findings of Fact and Conclusions of Law that he and Respondent Darren Bennett submitted on December 10, 2013.

under the facts and circumstances presented at the time. The standard does not permit judgment by hindsight . . . .").

2. Additionally, the ALJ's interpretation of relevant provisions of professional guidance contradicts the plain language of that guidance and departs from the opinions of the audit and accounting experts who testified in this case.

i. The ALJ failed to weigh the expert testimony and reports.

3. The Initial Decision's one-page discussion of the testimony and opinions of the four expert witnesses (a) contains no factual findings or conclusions; (b) makes no credibility determinations; (c) fails to explain the ALJ's reliance, or decision not to rely, on the experts' opinions or their explication of relevant professional standards; (d) does not attempt to resolve the material conflicts between the opinions of the Division's experts on the one hand and the Respondents' experts on the other; and (e) does not attempt to resolve the conflicts that arose between the Division's own two experts, most notably on the application of FAS 157 in the context of distressed markets. Additionally, although the Initial Decision states in a footnote that other portions of the Decision would "refer[ ]" to the "experts' evidence . . . as appropriate," Initial Dec. at 20 n.26, the portions of the Initial Decision that set forth the ALJ's findings and conclusions do not mention the expert reports or testimony *at all*.

4. In failing to consider and weigh the expert testimony and reports, the Initial Decision lacks an evidentiary foundation. For example, the Initial Decision fails to weigh or even consider the qualifications and testimony of *any* audit expert, including Respondents' expert witness, Sandra Johnigan, a current member of the AICPA's Auditing Standards Board with years of experience auditing financial institutions like TierOne. The sanction against Mr. Aesoph is therefore arbitrary and unlawful.

5. Further, the ALJ failed to consider the expert reports and testimony in interpreting the relevant professional guidance. This violated the basic function of an agency fact-finder to examine the full record and resolve factual disputes. *See Steadman v. SEC*, 450 U.S. 91, 98 (1981) (citing 5 U.S.C. § 556(d)); *cf. Nat'l Realty and Constr. Co. v. Occupational Safety and Health Review Comm'n*, 489 F. 2d 1257, 1267 & n.40 (D.C. Cir. 1973) ("To merit judicial deference, [an agency's] expertise must operate upon, not seek to replace, record evidence. . . . In short, the Commissioners attempted to serve as expert witnesses for the Secretary. This is not their role. The Secretary should have called his own expert or experts at the hearing.").

6. Because the ALJ failed to consider the expert reports and testimony in interpreting the professional guidance, the ALJ's interpretation of that guidance is unsupported and must be reviewed by the Commission.

ii. The ALJ failed to distinguish between distressed market prices and estimated fair value under FAS 157.

7. Under FAS 157, fair value must be estimated based on an "orderly transaction" rather than "a forced transaction (for example, a forced liquidation or distress sale)." (J.P.F. ¶ 55 (Resp'ts Ex. 45, FAS 157 ¶ 7).) In September 2008 the Commission's Office of the Chief Accountant and the Financial Accounting Standards Board jointly released guidance stating that "The results of disorderly transactions are not determinative when measuring fair value." (J.P.F. ¶¶ 58, 520–21 (Resp'ts Ex. 66, SEC Release No. 2008-234).)

8. The only witness to disagree with these provisions of GAAP was Professor Thakor, who was not qualified to opine on accounting matters and "was not offered or accepted as an expert in accounting." (J.P.F. ¶ 509 (Tr. 133:25–34:1 (Hon. Judge Foelak)).) Professor Thakor asserted that TierOne's fair value estimates should have been based only on "market conditions," even though, in 2008, TierOne's lending markets were heavily influenced by, and in

some cases dominated by, distressed sales. (Tr. 277:23–78:5 (Thakor).) According to Professor Thakor, distressed sales are simply "part of the market" and should be included in the fair value analysis. (Tr. 296:4–18, 335:13–36:8 (Thakor).) Professor Thakor's opinions violated FAS 157 and guidance issued by the Commission's Office of the Chief Accountant the year the audit was conducted.

9. The ALJ adopted Professor Thakor's non-GAAP interpretation of fair value, as evidenced by the Initial Decision's criticisms of the audit based on notions such as "market prices," "declines from quarter to quarter," "significant real estate declines," "decreasing real estate values," "significant decline in total sales and sale prices," and "continued market declines." *See* Initial Dec. at 14, 17, 29 n.33, 30. The Initial Decision dismisses FAS 157 as raised by Respondents "in defense of the charges," failing to recognize FAS 157 for what it is; an accounting principle directly relevant and applicable to the financial statements under audit. The ALJ therefore failed to appreciate the effect of distressed sales on prevailing market prices and the exclusion of distressed sales from the accounting concept of fair value. This violated FAS 157 and related guidance.

10. The Initial Decision does not mention the concept of "Level 3 inputs" under FAS 157. Thus, the ALJ failed to recognize that TierOne's fair value estimates were inherently imprecise and required significant judgment. Further, by neglecting to consider the concept of Level 3 inputs, the ALJ failed to appreciate that TierOne's fair value estimates involved internal evaluations of real estate assets in highly disorderly markets. TierOne's Level 3 fair value estimates were not conducive to applying uniform discounts to older appraisals or, alternatively, ordering new appraisals in disorderly markets. (J.P.F. ¶¶ 65–69.)

11. The Initial Decision assumes that TierOne was required to obtain "current" appraisals in estimating the fair value of real estate collateral. *See, e.g.*, Initial Dec. at 3. This was not only incorrect as a matter of accounting standards—neither FAS 114 nor FAS 157 nor any other accounting standard imposes any such obligation—but it also contradicted the record evidence, including testimony from the Division's own auditing expert, who conceded that neither GAAP nor any other professional standard requires a current appraisal when evaluating estimates of the fair value of collateral-dependent loans under FAS 114 and FAS 157. (J.P.F. ¶ 68.) The Initial Decision is therefore erroneous in that it misinterprets GAAP to require a current appraisal or a discount to an appraisal despite then-current accounting standards and Staff pronouncements that explicitly require the exclusion of disorderly transactions in estimating fair value.

12. The ALJ could not fairly evaluate Mr. Aesoph's audit procedures without a correct understanding of GAAP. The ALJ's failure to properly interpret and apply FAS 157 and related guidance requires Commission review of the Initial Decision's findings and legal conclusions.

iii. The ALJ Decision improperly interprets the professional guidance to require an audit of individual loan loss estimates and ignores the concept of professional judgment.

13. In concluding that the auditors did not obtain sufficient audit evidence regarding the Bank's loan loss estimates, *see* Initial Dec. at 30–31, the ALJ retroactively expanded the scope of an auditor's responsibility to include forming opinions on individual loan loss reserves. This amounted to rewriting auditing standards in effect at the time. (J.P.F. ¶ 78.)

14. Mr. Aesoph and his team were "responsible for evaluating the reasonableness of accounting estimates made by [M]anagement in the context of the financial statements taken as a

whole." (J.P.F. ¶ 78 (PCAOB Interim Auditing Standard AU § 342.04).) Auditors do not express an opinion regarding any individual accounting estimate; the auditor's opinion is on the financial statements. (J.P.F. ¶ 78.) Mr. Aesoph and his team were not expected to "function as an appraiser and [were] not expected to substitute [their] judgment for that of [TierOne] management." (J.P.F. ¶ 86 (AU § 328.38).) Mr. Aesoph appropriately fulfilled his duty to assess the reasonableness of the ALLL estimate by "[r]eview[ing] and test[ing] the process used by management to develop the estimate." (J.P.F. ¶ 80 (AU § 342.10).). Mr. Aesoph and his team examined individual loans to (1) understand and assess TierOne's process for estimating the ALLL and (2) gather sufficient evidential material to determine whether that process reasonably considered relevant factors. They were not opining on individual loans. (J.P.F. ¶¶ 78–97.) Because the ALJ construed the professional guidance as requiring Mr. Aesoph and his team to arrive at audit conclusions as to individual impaired loans, the ALJ violated relevant professional standards, including AU § 328 and AU § 342.

15. The Initial Decision never mentions the concept of "professional judgment" under the auditing standards. Under AU § 230, professional judgment affects all facets of an audit, including selecting "areas to be tested and the nature, timing, and extent of the tests to be performed"; "interpreting the results of audit testing and evaluating audit evidence"; and "evaluating the reasonableness of accounting estimates." (J.P.F. ¶ 74 (Resp'ts Ex. 55, AU § 230.11).) The concept of professional judgment was especially critical to Mr. Aesoph's evaluation of TierOne's FAS 114 accounting and FAS 157 fair value estimates, because applying both of these accounting standards requires a significant amount of judgment. The ALJ's failure to apply the concept of professional judgment led to erroneous conclusions regarding the audit procedures and the audit evidence Mr. Aesoph and his team obtained and evaluated.

16. The ALJ's failure to properly apply AU § 230, AU § 342, and AU § 328 led the ALJ to misunderstand the significance of audit evidence Mr. Aesoph and his team indisputably obtained and reviewed, including, among many other pieces of audit evidence, an analysis showing that TierOne booked losses of nearly 30% on impaired Nevada loans. Initial Dec. at 33.

iv. The ALJ improperly applied the documentation standards of AS No. 3.

17. The Initial Decision improperly applies the audit documentation standard as the equivalent of an evidentiary rule to exclude from consideration testimony from both the Respondents and from expert witnesses regarding audit procedures performed and audit evidence obtained. Nothing in AS No. 3 permitted the ALJ to ignore the record evidence; to the contrary, she was required by the APA and due process to consider *all* record evidence.

18. For example, the ALJ assumes, on the basis of one sentence in one work paper, that the auditors failed to appreciate the market deterioration of 2008. *See* Initial Dec. at 31. Multiple work papers clearly demonstrate the auditors' recognition of the prevailing market conditions. (J.P.F. ¶¶ 163–64.) Under AS No. 3 (and as required by the APA and due process, as explained below in Section III(B)), the ALJ was obliged to review the entire audit and hearing record, not just the portions the Division selectively cited in an attempt to prove its allegations. The failure to do so is grounds for reversal.

19. The ALJ further assumed that the auditors should have documented audit conclusions for each individually impaired loan. *See* Initial Dec. at 18 n.22. This violated AS No. 3, which states that auditors must "document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." (J.P.F. ¶ 106 (Resp'ts Ex. 49, AS No. 3 ¶ 6).) Here, the "relevant financial statement assertion" was the ALLL, not individual impaired loans.

20. The ALJ failed to consider the entirety of the audit record or to put the audit record in the proper context. The sufficiency of documentation under AS No. 3 is assessed from the standpoint of "an experienced auditor" with "a reasonable understanding of audit activities." The guidance assumes that this "experienced auditor . . . has studied the company's industry as well as the accounting and auditing issues relevant to the industry." (J.P.F. ¶ 107 (Resp'ts Ex. 49, AS No. 3 ¶ 6).) Moreover, because it would be impractical to document every fact considered, observation made, or conversation with management, the professional standards acknowledge that an auditor's choice to document particular procedures or particular audit evidence—and the specific language used as part of the documentation—is a matter of professional judgment. (J.P.F. ¶¶ 432–33.) The ALJ is not an "experienced auditor" who has "studied the company's industry" and relevant "accounting and auditing issues"; at the least, therefore, the ALJ should have addressed the testimony of the expert CPAs, the auditors who testified at the hearing, and Respondents' evidence that an in-flight review of the audit documentation conducted by KPMG's National Office prior to the engagement team's audit sign-off found it adequate and in compliance with KPMG guidance. (J.P.F. ¶ 440 (Tr. 904:21-906:2 (Aesoph)).) The ALJ failed to do so and additionally failed to acknowledge that documentation is a matter of professional judgment.

21. For example, in concluding that a "conversation [among Mr. Aesoph, Mr. Bennett, and TierOne Controller David] Kellogg and . . . related procedures as to the 30% loss recognition [on Nevada impaired loans] are not documented," Initial Dec. at 19, 33, the ALJ (1) fails to discuss a memorandum that documents the Kellogg conversation and other conversations with management (J.P.F. ¶¶ 371–73); and (2) fails to credit a work paper analyzing loan losses by geographic market, which includes the 30% loss figure the ALJ concludes was undocumented

(J.P.F. ¶¶ 377–78). The ALJ compounds these errors in concluding that several other "procedures and considerations" were "not documented in the work papers," even though the work papers include the allegedly missing documentation. Initial Dec. at 18–20.

22. Additionally, the Initial Decision misunderstands a legal argument Mr. Aesoph raised regarding the Kellogg conversation. At trial, the Division implied that, despite the audit documentation and the trial testimony, the Kellogg conversation never took place. (Tr. 1789:10–14 (Division's Counsel).) In response, Mr. Aesoph argued that to support its argument, the Division had the burden to call Mr. Kellogg, particularly given his cooperation agreement with the Staff, to rebut Mr. Aesoph and Mr. Bennett's uncontradicted testimony. (Aesoph Post-Trial Br. at 42–47.) It was the *Division's burden* to prove its allegations by a preponderance of the evidence. *Steadman v. SEC*, 450 U.S. 91, 96–98 (1981). And the Initial Decision erred in discrediting unrebutted testimony simply because Respondents did not call a witness cooperating with the Division.

v. The ALJ Decision misinterprets AS No. 5 and the relevant financial statement assertion to which key financial statement controls were directed.

23. AS No. 5 required Mr. Aesoph and his team to test controls that addressed the risk of misstatement of the relevant "financial statement assertion," the ALLL. The Initial Decision defines the control objective as "the risk associated with the reliability or validity of appraisals in valuing collateral for FAS 114 loans," rather than the risk of misstatement of the ALLL. Initial Dec. at 28. This is contrary to AS No. 5.

24. The relevant GAAP (most notably, FAS 114 and FAS 157) required consideration of a number of factors in valuing TierOne's real estate collateral. A control focusing only on a single data point, such as appraisals, would not have satisfied AS No. 5. (J.P.F. ¶ 248.) The auditors consequently performed procedures to understand and test a variety of controls relevant

to the entirety of the Bank's loan loss estimation process. (J.P.F. ¶ 250.) Specifically, they tested controls addressing (1) identification of impaired loans, (2) reliability of inputs TierOne used in determining fair value estimates; (3) whether appropriate personnel estimated reserves for each loan on an individual basis; and (4) whether upper-level management was sufficiently monitoring the overall ALLL estimate, including the FAS 114 component. (*Id.*) Through these key controls, the team tracked each step of the FAS 114 accounting process, because it was that entire process that resulted in the relevant "financial statement assertion" under AS No. 5. (J.P.F. ¶ 248.) By misinterpreting AS No. 5 to apply to the "reliability or validity of appraisals" rather than the relevant financial statement assertion, the Initial Decision misunderstood the audit findings regarding internal controls over financial reporting.

B. The ALJ's Failure to Consider the Evidence Violated the Administrative Procedure Act and Due Process and Resulted in Erroneous Findings and Conclusions

25. Under the APA, "[a] sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence." 5 U.S.C. § 556(d). The written decision must demonstrate the fact-finder's consideration of the "whole record" and must "show the ruling on each finding, conclusion or exception presented," including "all the material issues of fact, law, or discretion presented." 5 U.S.C. § 557(c)(A).

26. The agency must consider "evidence on *both* sides; evidence that is substantial viewed in isolation may become insubstantial when contradictory evidence is taken into account." *Landry v. FDIC*, 204 F.3d 1125, 1140 (D.C. Cir. 2000) (emphasis in original); *see also Siegel v. SEC*, 592 F.3d 147, 155 (D.C. Cir. 2010). It is reversible error for an agency to "pa[y] no heed to [respondent's] evidence." *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1098 (D.C. Cir. 2005). As the Commission held earlier this year, an ALJ must have "a sufficient basis

on which to conclude" that the Division has proved each of its allegations. *Pelosi*, Inv. Advisors Act Rel. No. 3805, 2014 WL 1247415, at *3 (Mar. 27, 2014). On technical matters the Division must produce "expert testimony . . . or other authoritative evidence." *Id.*

27. Due process similarly requires that an agency base its decisions on a "full . . . appreciation of all of the evidence"; the agency cannot simply "review selected parts of the record . . . while ignoring other matters of record." *Cinderella Career and Finishing Schools, Inc. v. FTC*, 425 F.2d 583, 585 n.3 (D.C. Cir. 1970). Courts expect "that agencies will treat fully 'each of the pertinent factors' and issues before them"; otherwise, "the opportunities for notice and hearing in administrative proceedings would be largely illusory, with agencies free to disregard those facts or issues that prove difficult or inconvenient." *Tenneco Gas v. FERC*, 969 F.2d 1187, 1214 (D.C. Cir. 1992) (quoting *Public Serv. Comm'n of N.Y. v. Federal Power Comm'n*, 511 F.2d 338, 345 (D.C. Cir.1975)).

28. The Initial Decision fails to satisfy these requirements.

i. Internal Controls: The ALJ Decision ignores record evidence in its conclusions regarding the audit of the Bank's internal controls.

29. In concluding that the internal controls procedures failed to satisfy professional standards, and in concluding that Mr. Aesoph should have identified a "material weakness" in TierOne's internal controls over financial reporting, the Initial Decision focuses on the audit test work over a single internal control entitled "Appraisal Review." *See* Initial Dec. at 13, 28. Because that control was designed to evaluate real estate appraisals at loan origination, rather than at the time of loan impairment, the Initial Decision concludes that "there is no evidence that [this or other] controls sufficiently addressed the risk of collateral overvaluation at year-end." Initial Dec. at 28. With respect to other controls Mr. Aesoph and his team evaluated, the Initial Decision concludes that "the record does not indicate that [Bank Management] performed any

specific procedures to effectively address collateral overvaluation." Initial Dec. at 13. This analysis fails to address the full evidentiary record.

30. Mr. Aesoph and his audit team tested a number of other controls that addressed the risk of misstatement of the impaired loan portion of the ALLL. For example, one control, which is not mentioned in the Initial Decision, was designed to evaluate TierOne's loan-by-loan FAS 114 estimates. That control is depicted in the chart attached as Exhibit B to this Petition (a chart admitted into evidence before the ALJ) and is listed as "Finance Department (Controller) Reviews FAS 114 Templates." The audit work papers explain that this control involved the preparation of individual FAS 114 templates by TierOne Credit Administration personnel; review and approval of each of those templates by the Finance Department, i.e., Controller David Kellogg; and review and approval of individual loan loss estimates and the overall ALLL by the Asset Classification Committee, of which Mr. Kellogg was a member. (J.P.F. ¶¶ 279–80.)

31. Audit expert Sandra Johnigan described Mr. Kellogg's review of individual FAS 114 templates as a "strong control" because "another separate party [was] looking at [the estimated losses on individual loans] and seeing all the information that was used, and concurring on the method that was used and the amounts that were arrived at." (J.P.F. ¶ 280 (Tr. 2022:13–17 (Johnigan)).) The Division's audit expert, Mr. Barron, conceded that "review of the supporting documentation by someone other than the group that actually did the estimation could have been an effective control" and that Mr. Kellogg was an appropriate person to conduct that review. (J.P.F. ¶ 280 (Tr. 1095:9–12 (Barron)).) The Initial Decision does not discuss this audit documentation or this expert testimony.

32. In addition to this control, the Initial Decision neglects to discuss work papers and testimony describing other audit test work Mr. Aesoph and his team performed on additional key controls. (J.P.F. ¶¶ 252–300.)

ii. The FAS 114 Portion of the ALLL: The ALJ failed to address evidence regarding procedures Mr. Aesoph's team indisputably performed.

33. In discussing the substantive audit procedures applied to TierOne's FAS 114 accounting, the Initial Decision weighs only the evidence submitted by the Division. The initial decision fails to address much of the evidence Mr. Aesoph submitted in his defense.

34. For example, the ALJ makes numerous unsupportable findings regarding the auditors' evaluation of individual impaired loans: that "the auditors' procedures to address [discounts to individual loans] are not evident from the work papers"; that Mr. Aesoph and Mr. Bennett "could not point to loan-specific evidence or documented procedures to support TierOne's decision to not discount . . . appraisals in the wake of deteriorating market conditions"; and that Mr. Aesoph "fail[ed] to point to any information in [TierOne's loan] files that supports the conclusion that TierOne's use of numerous undiscounted appraisals from the first half of 2008 or earlier was reasonable at year-end 2008." Initial Dec. at 31–32. The report by audit expert Sandra Johnigan, which contains an appendix that discusses every impaired loan evaluated by Mr. Aesoph and his audit staff, cites work papers evaluating each loan; describes audit evidence that the auditors obtained as to each loan; and demonstrates why Mr. Aesoph's conclusion about TierOne's ALLL, including the FAS 114 portion, was supported by the audit record. It appears from the Initial Decision that the ALJ did not review Ms. Johnigan's report or consider her testimony. *See* Initial Dec. at 21.

35. Another example of the ALJ's failure to address the full record below is the Initial Decision's focus on a single two-page work paper, the "FAS 114 Procedures Memo." According

to the ALJ, "the description of the audit work in the FAS 114 procedures memo shows that Respondents did not sufficiently assess TierOne's collateral valuation decisions." Initial Dec. at 31. The documentation of the substantive FAS 114-related audit procedures included more than the two-page procedures memo. The record shows that the audit team reviewed extensive information relevant to their audit objective of evaluating TierOne's estimation process: appraisals; TierOne's FAS 114 templates; loan-by-loan findings by the Bank's federal regulator, the Office of Thrift Supervision; management assumptions related to FAS 157 fair value estimates; data showing trends in the Bank's impaired loan losses and market-by-market loss recognition; and information from TierOne's loan files, including interim and final credit analyses, borrower-supplied financial statements, and other information. (J.P.F. ¶¶ 321–22, 335–40, 361.) These were procedures a reasonable auditor would perform, and they provided a sufficient basis to conclude that management's estimation process was working and led to a reasonable result. (J.P.F. ¶ 361.)

36. The ALJ concludes that FAS 157 played no role in the audit or the auditors' "assessment of TierOne's fair value estimates." Initial Dec. at 18, 33. This is contrary to undisputed evidence. The record shows that Mr. Aesoph and his team appropriately relied on FAS 157 as the key piece of professional guidance on fair value. The work papers document the audit team's consideration of FAS 157 in various locations. (J.P.F. ¶ 119.) Further, in the notes to its year-end 2008 financial statements, TierOne specifically addressed the application of FAS 157. (J.P.F. ¶ 230.) Mr. Aesoph provided detailed comments on those disclosures and their application to the bank's ALLL estimation methodology, and he tied the FAS 157 disclosures to the audit work his team performed on TierOne's impaired loans. (*Id.*) The Division's audit expert, John Barron, conceded that an accountant cannot mention the word "fair value" without

implicating that guidance, meaning that references to fair value in the work papers were necessarily references to FAS 157. (Tr. 2242:16–43:11 (Barron).) The concept of fair value under FAS 157 was, in Mr. Aesoph's words, "baked into [the auditors'] thinking." (J.P.F. ¶ 376 (Tr. 1779:6–7 (Aesoph)).) The Initial Decision does not discuss this evidence.

37. The Initial Decision concludes that "[i]t is undisputed that TierOne did not consistently follow [its policy of] tr[ying] to estimate collateral value declines in real estate by discounting appraised values, which are older than six months." Initial Dec. at 19. This fact was not "undisputed"; as the record demonstrates, Mr. Aesoph obtained and reviewed audit evidence showing the contrary to be true. For example, on individual loans the Division claims were "not discounted," TierOne recognized average losses during 2008 of over 25%, a quarter of the loan balance. (Resp'ts Ex. 42, Johnigan Report at 141.) Based on the full audit record, Mr. Aesoph concluded that TierOne was reasonably considering each individual piece of loan collateral and the market in which that collateral was located to arrive at its fair value estimates. (J.P.F. ¶¶ 360–61.) And describing TierOne's estimation process as a "policy" is, in and of itself, a clear error. Even so, nothing in the audit record suggested to Mr. Aesoph that the Bank had abandoned, selectively or otherwise, its estimation approach.

38. The Initial Decision assumes that TierOne should have discounted real estate appraisals based on "market declines." Initial Dec. at 30. This would have violated FAS 157. (J.P.F. ¶ 155.)

39. TierOne's consideration of appraisals and other information as part of its loan loss estimation process was more complex than the Initial Decision acknowledges. TierOne obtained 26 new appraisals in the second half of the year, most of them in markets that were less disorderly than Nevada during that time. (J.P.F. ¶ 323.) Appraisals in Nevada had become less

reliable in the second half of 2008 due to market disruptions, and under FAS 157, appraisals based on forced sales prices in distressed markets were not indicative of fair value. (J.P.F. ¶¶ 159–160.) As Mr. Aesoph observed, the Bank's process included more than consideration of appraisals. Instead, the Bank's process included obtaining and evaluating market information at year-end, such as listing prices, sales prices, and construction progress. (J.P.F. ¶¶ 344–45.) Mr. Aesoph and his audit team evaluated all of this evidence to conclude that the Bank's estimation process appeared to be working and led to a reasonable result, including the 22% loss recognition on TierOne's impaired loans and the nearly 30% losses booked in Nevada. (J.P.F. ¶ 361.)

40. The Initial Decision improperly assumes that the 30% losses booked on Nevada impaired loans "did not necessarily pertain to market declines in that year alone." Initial Dec. at 33 & n.36. It was inappropriate to assume that losses booked in 2008 arose in an unspecified prior period. (J.P.F. ¶ 477.) The Division's proffered audit expert, Mr. Barron, conceded that losses are measured under FAS 114 and recorded only at the time a loan is deemed impaired. (J.P.F. ¶ 477.) The ALJ ignores this evidence in the Initial Decision.

iii. Additional Loan Losses Booked in the First Quarter of 2009: The record disproves the allegation that appraisals received in the first quarter of 2009 triggered AU § 561.

41. In concluding that Mr. Aesoph and his team violated AU § 561, the ALJ relies exclusively on evidence that the Division proffered to support its allegations: *viz.*, two appraisals the auditors received during their review in April 2009 of the Bank's first quarter 2009 financial statements that showed a decline in collateral value for two of TierOne's loans. Other evidence, however, contradicted the charge that these appraisals required evaluation under AU § 561. For example, throughout 2008, TierOne had already booked millions of dollars in losses on the lending relationship to which the two new appraisals pertained, consistent with numerous other

examples of TierOne management exercising judgment throughout 2008 to increase, rather than decrease, loan loss provisions and reserves. (J.P.F. ¶¶ 403–05, 422.) Further, another 2009 appraisal, not mentioned by the Division in the OIP, showed a $1.5 million excess collateral value over TierOne's estimate. (J.P.F. ¶ 419.) The ALJ failed to consider this full context in analyzing the Divisions' allegations under AU § 561.

42. The ALJ fails to acknowledge that neither Mr. Barron, the Division's audit expert, nor any other witness testified that the two new appraisals received in 2009 would have required a restatement of TierOne's year-end 2008 financial statements or that the cumulative adjustments caused by those appraisals were material to the 2008 financial statements taken as a whole. (J.P.F. ¶ 424 (Tr. 1159:8–9 (Barron)).) The ALJ ignores this lack of record support for the Division's AU § 561 allegations.

43. The Initial Decision concludes that Mr. Aesoph should have considered "whether additional provisions due to collateral value deterioration associated with the loans affected by the new appraisals, if recorded in 2008, would have significantly reduced TierOne's reported net interest income after provisions of $2.9 million or turned that figure into a loss." Initial Dec. at 35. The Initial Decision does not explain why a reasonable investor would focus on the $2.9 million net interest income figure while ignoring the $93 million pre-tax loss TierOne booked in 2008. Neither of the two audit experts who testified at trial (on behalf of both the Division and Respondents) supported this conclusion. (See J.P.F. ¶ 424.)

44. The ALJ's failure to consider evidence contrary to the Division's AU § 561 allegations requires Commission review.

iv. The OTS Report of Examination: the ALJ made erroneous findings regarding the auditors' review and evaluation of regulatory activity affecting TierOne in 2008.

45. The record shows that Mr. Aesoph and his team devoted close attention to regulatory actions by the Office of Thrift Supervision in 2008. For example, shortly after Mr. Aesoph received the OTS's 2008 Report of Examination, he asked Mr. Bennett to draft a memorandum analyzing the significant criticisms contained in the Report and explaining how TierOne was addressing them. (J.P.F. ¶¶ 194–97.) Mr. Aesoph consulted experienced audit partners at KPMG to obtain their views on the OTS Report (J.P.F. ¶ 199), and he engaged the services of KPMG regulatory specialists to interpret the practical consequences of the OTS's actions (J.P.F. ¶ 198). Mr. Aesoph and Mr. Bennett also spoke directly to a senior official at the OTS, Field Manager Douglas Pittman, to confirm that the evidence the auditors had obtained was consistent with the views that the OTS itself held. (J.P.F. ¶ 204.) The Division's auditing expert, Mr. Barron, conceded that the audit procedures applied to the OTS report and regulatory activity demonstrated due care and professional skepticism. (J.P.F. ¶ 491.)

46. The Initial Decision concludes, contrary to the record, that during his phone call with Mr. Aesoph and Mr. Bennett, OTS Field Manager Douglas Pittman "gave no indication that . . . TierOne's [remedial] actions [in response to OTS regulatory activity] were effective." Initial Dec. at 12–13. This ignores the testimony of Mr. Pittman himself, who explained at trial that (1) by the time he had spoken with Messrs. Aesoph and Bennett in February 2009, he had received and reviewed a number of required submissions from the Bank; (2) TierOne management was receptive to the OTS's comments and was complying with the requirement to submit additional information to federal regulators; (3) he (Mr. Pittman) believed that Management had the ability to address the issues identified by the OTS and was, in fact,

appropriately addressing those issues; and (4) the Bank had the ability to perform under all terms of a supervisory agreement it had entered into with the OTS. (J.P.F. ¶¶ 204–10, 400.)

v. The Department of Treasury's Office of Inspector General Report: The ALJ made impermissible assessments in hindsight based on information not known to the auditors during the time of the audit.

47. The Initial Decision notes that the Department of Treasury's Office of Inspector General issued a report in 2011, finding in part that TierOne failed primarily because of significant losses in its construction and land-development loan portfolio. Initial Dec. at 5. The Initial Decision relies upon the conclusions in this report to illustrate and emphasize TierOne's failure to order updated appraisals when modifying loans or when material deterioration in property values was evident. *Id.* The ALJ's reliance on this report to emphasize TierOne's failure to order updated appraisals constitutes impermissible hindsight assessment: neither the report nor the information contained within the report was available to the auditors at the time the audit was conducted. Rule 102(e) "does not permit judgment by hindsight, but rather compares the actions taken by the accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation." 63 Fed. Reg. 57164 at 57168. Nor can it be reasonably inferred from those 2009 appraisals that the fair value estimates made in 2008 were contrary to then-current market information. The ALJ's consideration of this report in reaching its Findings of Fact and Conclusions of Law was erroneous.

C. The ALJ Erroneously Admitted the Expert Report and Testimony of a Witness Unqualified to Give the Opinions He Proffered

48. Before trial, Mr. Aesoph moved to exclude the report and testimony of the Division's proffered economic expert, Professor Anjan Thakor. Mr. Aesoph explained in his pretrial motion that Professor Thakor's opinions were contrary to FAS 157. For example,

Professor Thakor assumed that at the height of the 2008 real estate crash, sales prices in disorderly markets such as Las Vegas, Nevada, equated to fair value under GAAP. Based on this assumption, and relying exclusively on unadjusted indices showing declines in publicly reported market prices, Professor Thakor "recalculate[d] the 'Required ALLL' at the *borrower* level" for each of TierOne's impaired loans. (Div. Ex. 191 (Thakor Report at ¶ 10 (emphasis in original)).) This analysis did not comply with GAAP and bore no relevance to the year-end 2008 audit. The ALJ erroneously denied Mr. Aesoph's pretrial motion and permitted Professor Thakor to testify at trial.

49. Professor Thakor's testimony at trial also should have been excluded. Professor Thakor purported to interpret FAS 157 during his testimony although he is not CPA or an accounting expert and "was not offered or accepted as an expert in accounting." (J.P.F. ¶ 509 (Tr. 133:25–34:1 (Hon. Judge Foelak)).) Professor Thakor claimed that fair value under FAS 157 is defined by "market forces," and because distressed sales are part of the market, they should be used to estimate fair value. As explained above in Section III(A)(ii), this "market forces" theory of fair value contravenes GAAP, including guidance from the Commission's Office of the Chief Accountant issued in late 2008.

50. Additionally, Professor Thakor failed to acknowledge the magnitude of the market upheaval in 2008 and the consequent distortion in his "recalculations" of TierOne's loan losses. For example, when adjusted to exclude identifiable distressed sales, the indices on which Professor Thakor relies show market declines of less than 20% in Nevada. This suggests that the Bank's 30% loan loss recognition in Nevada was conservative and that losses booked in other markets were within the range of reasonableness. (J.P.F. ¶¶ 504–07.)

51. Despite the flaws in Professor Thakor's opinions, the ALJ denied Mr. Aesoph's renewed motion to exclude his report and testimony. Initial Dec. at 4. Additionally, the Initial Decision did not address evidence that contradicted Professor Thakor's opinions, including testimony from the Division's audit expert, who testified that estimating fair value is "not simply a matter of applying a housing price index." (J.P.F. ¶ 515 (Tr. 1232:7–8 (Barron)).) These errors require Commission review.

D. The Division Failed to Develop a Complete Investigatory Record

52. During the audit of TierOne, Mr. Aesoph and his team examined the Bank's extensive loan files in various contexts, including as part of their FAS 114 procedures. In total, the work papers document over 200 instances in which the auditors reviewed TierOne's loan files. (J.P.F. ¶ 451.) The files contained loan-specific information such as credit histories, appraisals, and interim and annual credit reviews and provided evidence to the auditors that the Bank's loan loss estimates were adequately supported. (J.P.F. ¶¶ 335–46.) The evidence presented at the hearing included documents sampled directly from the loan files that the engagement team reviewed during the 2008 audit. (J.P.F. ¶ 338.) Despite the importance of the loan files to this proceeding, the Division failed to preserve a full investigatory record, obtaining files for only one-third of the FAS 114 loans on which its allegations rest. (J.P.F. ¶¶ 451–54.)

53. The Division's two experts did not review even the incomplete subset of loan files the Division obtained. (J.P.F. ¶ 454.) The Division's audit expert, Mr. Barron, conceded that if he were auditing TierOne, "the loan file is one of the first places [he would] go to get some corroborating evidence," and he had "no doubt that the auditors, Mr. Aesoph and Mr. Bennett, reviewed the loan files." (J.P.F. ¶ 482 (Tr. 1326:16–18 (Barron)).) He admitted that information in the loan files might have affected his expert opinions, had he reviewed them. (J.P.F. ¶ 483

(Tr. 1204:9–13 (Barron)).) Mr. Barron, however, did not consult the loan files, nor did he ask for them from the Division. (J.P.F. ¶ 483 (Tr. 1321:10–11 (Barron)).) Moreover, when Mr. Barron was confronted with documents from TierOne's loan files during cross-examination, he admitted that they did, in fact, change his conclusions and that opinions contained in his expert report were incorrect. (J.P.F. ¶ 484.) The ALJ failed to address this testimony, instead concluding that Mr. Aesoph "had the full opportunity to point to information in the loan files to justify his conduct." Initial Dec. at 3. This ruling was erroneous. Mr. Aesoph was not required to "justify" his conduct at trial. To the contrary, it was the Division's burden to prove a violation of Rule 102(e).

54. The ALJ ruled that the Division's incomplete investigation was a matter of "prosecutorial discretion." Initial Dec. at 3. Prosecutorial discretion can only extend so far, however. Without a complete record, the Division could not carry its burden of proving its allegations by a preponderance of the evidence. *Steadman v. SEC*, 450 U.S. 91, 102 (1981); *Pelosi*, Inv. Advisors Act Rel. No. 3805, 2014 WL 1247415, at *3 (Mar. 27, 2014).

E. The Defects in the Proceedings Below, Alone and in Combination, Violated Mr. Aesoph's Right to Due Process

55. A Rule 102(e) proceeding is a serious matter, and its consequences for a professional such as Mr. Aesoph "should not be underestimated." *Checkosky v. SEC*, 23 F.3d 452, 479 (D.C. Cir. 1994). In agency adjudications such as this one, both the Administrative Procedure Act and standards of due process are intended to assure fundamental fairness. Agencies must engage in "reasoned decisionmaking" driven by a "logical and rational" adjudicatory process before issuing orders with such profound consequences. *Allentown Mack Sales & Service, Inc. v. NLRB*, 522 U.S. 359, 374 (1998).

56. As explained above, the Initial Decision made several fundamental errors that violated Mr. Aesoph's right to basic fairness:

- The ALJ retroactively applied novel—and incorrect—interpretations of relevant accounting principles and auditing standards, contravening both the plain language of the guidance and the profession's accepted interpretations of that guidance at the time of the audit. This deprived Mr. Aesoph of fair notice and subjected him to unduly vague and subjective standards of conduct.

- Moreover, this retroactive application of novel professional standards amounted to impermissible rulemaking by enforcement. The Initial Decision improperly determined that the Division, although it has no power to promulgate auditing or accounting standards, has "discretion" to engage in rulemaking by enforcement. Initial Dec. at 3.

- The ALJ failed to consider evidence Mr. Aesoph submitted in his defense—including testimony from his two expert witnesses—and further failed to resolve material factual disputes.

- The Division conducted an incomplete investigation by failing to obtain loan files for two-thirds of the loans it put at issue, despite the fact that the audit team documented its reliance on the loan files hundreds of times in the 2008 work papers. This deprived Mr. Aesoph of a full and fair opportunity to prepare and present his defense. The ALJ sustained charges against Mr. Aesoph despite this defect, and despite the fact that the lack of loan files to support the Division's charges amounted to a failure of proof.

- The ALJ permitted the Division to use an admittedly unqualified expert, Professor Thakor, to redefine the concept of fair value contrary to the GAAP that applied during the time of the year-end 2008 audit. Moreover, the ALJ adopted Professor Thakor's non-GAAP "market forces" theory of fair value.

These defects, alone and in combination, infringed Mr. Aesoph's right to due process.

F. The Division's Case Fails to Satisfy the Requirements of Rule 102(e)

i. The Division offered no evidence to establish what a "reasonable accountant" would have done under the circumstances of the year-end 2008 audit.

57. Rule 102(e) "does not permit judgment by hindsight, but rather compares the actions taken by the accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation." 63 Fed. Reg. 57164 at 57168.

The Division suggested that Mr. Aesoph and his team should have applied uniform, market-price-based discounts to each impaired loan in violation of FAS 157 and other professional guidance. However, the Division neglected to present evidence of what specific actions a "reasonable accountant" would have taken if faced with the conditions of the year-end 2008 audit. The Division therefore failed to carry its burden of proof and the Initial Decision's findings and conclusions lack an evidentiary basis.

ii. The "repeated instances" prong of Rule 102(e) cannot be applied to procedures performed on one subset of one balance sheet account.

58. The Division alleged that Mr. Aesoph engaged in "repeated instances of unreasonable conduct" under Rule 102(e), and the Initial Decision adopts that theory as an alternate ground to sanction Mr. Aesoph. Initial Dec. at 36 n.38. But because of the narrow scope of the allegations in this case, which are confined to audit procedures applied to the FAS 114 portion of TierOne's ALLL, that provision of Rule 102(e) cannot apply.

59. The phrase "repeated instances" requires at least "two separate instances of unreasonable conduct occurring within one audit." 63 Fed. Reg. 57164 at 57169. For example, a failure to "gather evidential matter for more than two accounts" or an erroneous certification of GAAP accounting "in more than two accounts" could violate the "repeated instances" prong of Rule 102(e). *Id.* "By contrast, a single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute a violation of this subparagraph." *Id.*

60. The Commission, overruling an ALJ decision, previously held that "[t]here is no requirement that the two instances pertain to different accounts in that audit." *Hall*, Exchange Act Rel. No. 61162, 2009 WL 4809215, at *7 (Dec. 14, 2009). Even if that holding is consistent with Rule 102(e), it does not fit the allegations here, which involve only a *subset* of a single

account—the FAS 114 portion of TierOne's ALLL. Here, there are no "repeated instances" on which to base a Rule 102(e) violation.

iii. The Initial Decision collapses the distinction between a single instances of "highly unreasonable" conduct and "repeated instances" of unreasonable conduct.

61. The Initial Decision concludes that the audit procedures applied to TierOne's FAS 114 accounting and internal controls over financial reporting were a single instance of "highly unreasonable conduct." At the same time, the Initial Decision concludes that these same acts individually amount to "repeated instances" of unreasonable conduct. This ruling erroneously conflates the distinct Rule 102(e) standards.

iv. There is no evidence that Mr. Aesoph engaged in the kind of extreme conduct required for a Rule 102(e) sanction.

62. The sanction against Mr. Aesoph is arbitrary and capricious. There is no dispute that Mr. Aesoph and his team recognized the risks inherent in the FAS 114 portion of TierOne's ALLL and performed multiple procedures, spanning hundreds of pages of audit documentation, over that portion of the ALLL. Mr. Aesoph devoted an extraordinary number of hours to the 2008 audit, far in excess of hours spent in prior years, and demanded the same from his staff. Mr. Aesoph brought in multiple experts to assist with the audit, including a credit specialist, multiple forensic specialists, and members of KPMG's financial services regulatory practice group. Initial Dec. at 7. The Division's own auditing expert conceded the many instances of professionalism and due care set forth in the record. (J.P.F. ¶¶ 471–75, 481–82, 489–91.) Likewise, the Initial Decision itself describes the work performed by Mr. Aesoph and Mr. Bennett on other areas of the audit as in accordance with "the highest professional standards." Initial Dec. at 31.

63. Mr. Aesoph's conduct demonstrates diligence and good faith, and that conduct is not sufficient to trigger sanctions under Rule 102(e). Rule 102(e)'s heightened negligence provisions were "not intended to cover all forms of professional misconduct." 63 Fed. Reg. 57164 at 57165–66. Instead, they encompass only egregious lapses in professionalism evidencing a threat to the Commission's mission of protecting the investing public. *See id.* The Division's evidence—including the testimony of its own auditing expert, who not once suggested that the conduct at issue here was "egregious," "glaring," or anything close to that type of distant departure from professional standards, *McNeeley*, Exchange Act Rel. No. 68431, 2012 WL 6457291, at *15–16 (Dec. 13, 2012)—fell far short of this stringent standard. The discipline imposed against Mr. Aesoph lacks foundation or justification.

64. In assessing appropriate sanctions, the ALJ further erred in its application of the *Steadman* factors. *See Steadman v. SEC,* 603 F. 2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds,* 450 U.S. 91 (1981). The Initial Decision points to Mr. Aesoph's "vigorous defense of the charges" as evidence that Mr. Aesoph failed to recognize the alleged unreasonableness of his conduct. Initial Dec. at 37. Yet courts have made clear that defendants in SEC enforcement actions "are not to be punished because they vigorously contest the government's accusations." *SEC v. First City Financial Corp.,* 890 F.2d 1215, 1229 (D.C. Cir. 1989). Rather, this *Steadman* factor "is relevant only where defendants have violated court orders or otherwise indicate that they did not feel bound by the law." *Id.* (internal quotations omitted). Mr. Aesoph's conduct throughout the SEC investigation and during the ALJ hearing never once suggested that Mr. Aesoph felt unbound by the law. Rather, Mr. Aesoph has fully cooperated with the Commission. He also testified at trial that he carried ultimate responsibility for the audit, and if the engagement team had failed to obtain sufficient evidence in an area requiring heightened

scrutiny, Mr. Aesoph bore ultimate responsibility. (Tr. 726:8–727:2 (Aesoph).) Mr. Aesoph cannot be sanctioned for presenting the vigorous defense to which he is entitled.

65. Moreover, to the extent the Initial Decision's findings are premised on the absence of audit documentation, a sanction for failure to sufficiently document the audit in accordance with AS No. 3 is unprecedented. While the adequacy of audit documentation is frequently addressed in the PCAOB inspection process, it has never served as the basis for imposing sanctions under Rule 102(e).

IV.
CONCLUSION

Mr. Aesoph requests that the Commission grant his Petition for Review of the Initial Decision and, upon review, vacate the Initial Decision and dismiss the charges against him.

Dated: August 11, 2014

Respectfully submitted,

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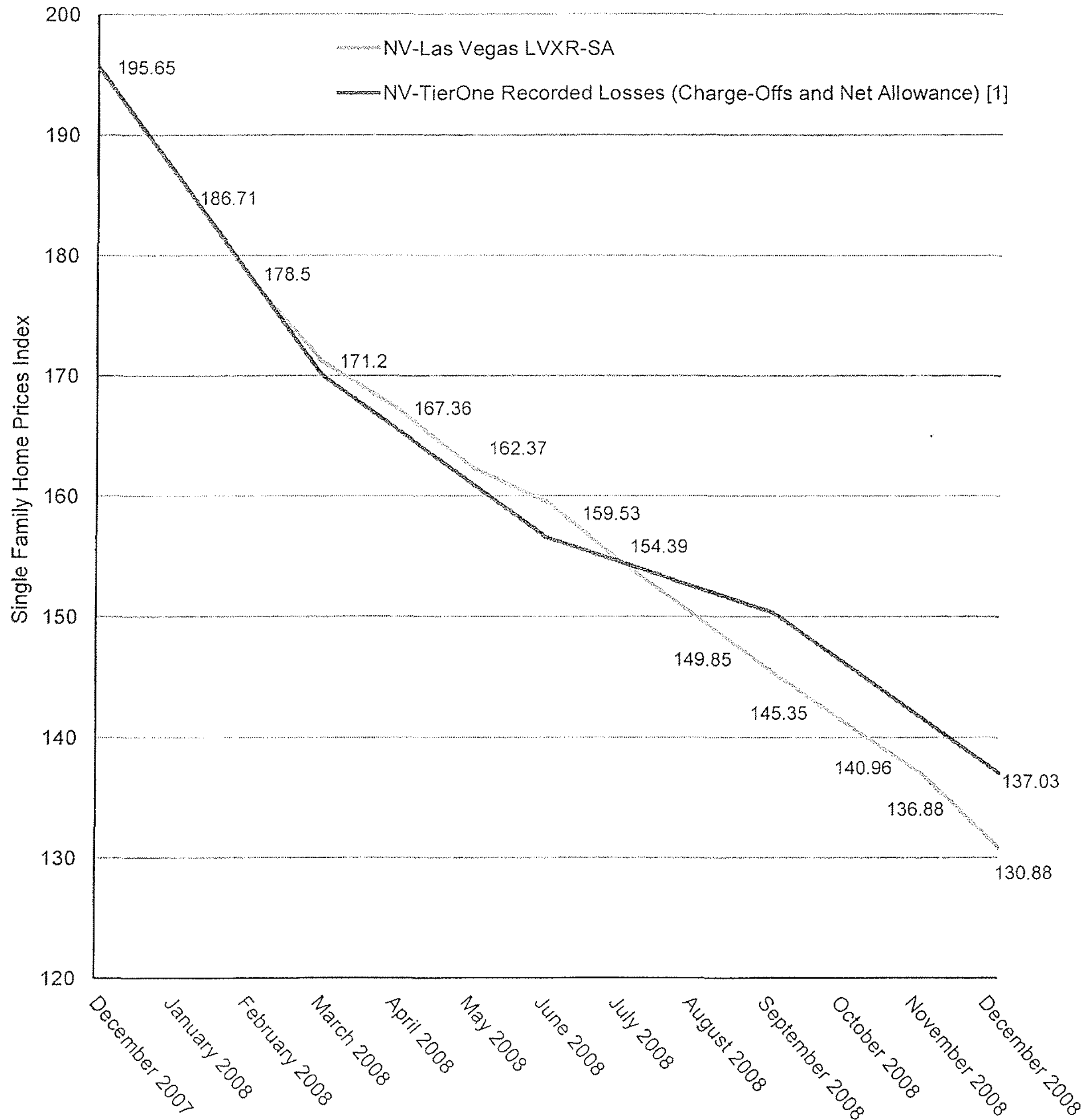
EXHIBIT A

To Respondent John J. Aesoph's

Petition for Commission Review of Initial Decision

Percentage Losses Recorded by TierOne on Nevada Impaired Loans Compared to Case-Shiller Index



Source: Case-Shiller Index; KPMG workpapers (KPMGTO0000402, KMPGTO0000409, KMPGTO0000905, KMPGTO0001812, KPMGTO0005590, KPMGTO0005374, KPMGTO0005485, KPMGTO0005487, KPMGTO0005527, KPMGTO0005488, KPMGTO0005496, KPMGTO0005499, KPMGTO0005504, KPMGTO0005511, KPMGTO0005519, KPMGTO0045655)
Note: Each Bates number reference is for the first page of analysis in the working papers.
[1] Losses are the sum of provisions and charge offs. The TierOne Losses are pegged to the Las Vegas, Nevada, Case-Shiller Index (as shown in the Barron Report) as of December 2007. Loans in analysis include: Carlos Escapa, Celebrate 50, Clearwater Estates, Double M Construction, Grand Teton Residential, HBD LLC, MME LLC, Mohave Sun, Rising Sun and Valley Heights.

Respondent's Joint Exhibit
R257

EXHIBIT B

To Respondent John J. Aesoph's

Petition for Commission Review of Initial Decision

ALLL Estimation Process

Respondents' Joint Exhibit
R260
A.P. No. 15168