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Before the
SECURITIES AND EXCHANGE COMMISSION

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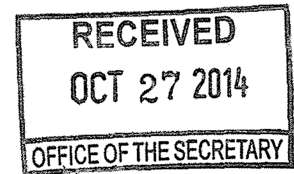

ADMINISTRATIVE PROCEEDING
File No. 3-15168

In the Matter of :

JOHN J. AESOPH, CPA, and
DARREN M. BENNETT, CPA

DIVISION OF ENFORCEMENT'S OPENING BRIEF IN SUPPORT OF ITS PETITION FOR REVIEW

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Pursuant to Rule 450(a), the Division of Enforcement ("Division") respectfully submits this opening brief in support of its petition for review of the Initial Decision in this matter. The Division takes exception to only two conclusions: the imposition of a one-year suspension from the privilege of practicing before the Commission against Respondent Aesoph, and a six-month suspension of the privilege against Respondent Bennett. In light of the law judge's well-supported findings of repeated and significant audit failures, more significant sanctions are warranted.

I. INTRODUCTION

Respondents John Aesoph and Darren Bennett repeatedly violated basic audit standards that require an auditor to use due care, employ professional skepticism, and gather competent evidence, particularly in a high-risk audit area. Further, Respondents have persistently refused to acknowledge any responsibility for their failures. Indeed, their principal defense highlights their fundamental disregard for their responsibilities as auditors: Respondents seek to avoid the consequences of their inadequate audit by claiming to have performed procedures that appear nowhere in their work papers, even though audit standards plainly state that auditors "must document the procedures performed, evidence obtained, and conclusions reached." AS No. 3 ¶ 6. Respondents' improper conduct, which demonstrates a serious abdication of core professional responsibilities both during the audit and throughout this litigation, requires strong sanctions.

In the Initial Decision, issued on June 27, 2014, Administrative Law Judge Carol Fox Foelak properly concluded that Respondents engaged in highly unreasonable conduct in connection with their year-end 2008 audit work over the Allowance for Loan and Lease Losses ("ALLL") account of TierOne Corporation, a holding company for TierOne Bank. More specifically, Respondents' improper professional conduct related to one component of the

ALLL: TierOne's estimates of losses on large, non-homogenous loans evaluated under Statement of Financial Accounting Standards No. 114 ("FAS 114").

It is undisputed – indeed, Respondents have conceded – that the FAS 114 portion of the ALLL was a high-risk area of the 2008 audit. TierOne assessed losses on its loans accounted for pursuant to FAS 114 by comparing the book value of the loan with the fair value of the collateral securing that loan: if the collateral value fell below the value of the loan, losses would result. Put another way, if the collateral value was overstated, losses risked being understated. However, despite the fact that 2008 saw historic real estate market declines in areas like Nevada, where TierOne's FAS 114 loans were concentrated, TierOne typically estimated collateral values using stale appraisals that were not discounted to reflect these precipitous market declines. Respondents were well aware of this practice; among other reasons, it was flagged in a scathing report from TierOne's federal regulator that Respondents received and reviewed before the audit. That report described the "inept" nature of TierOne's loan administration practices and downgraded TierOne to a bank with "unsafe and unsound" practices and conditions. As a result of the report's conclusions, the regulators increased TierOne's regulatory capital ratio levels – ratios that would have been directly and negatively impacted if TierOne had recognized additional loan losses. As the law judge succinctly put it:

> Given the convergence of risk and materiality in this area of the audit, there was heightened importance for Respondents to exercise professional skepticism, corroborate management representations, and perform extensive audit procedures and obtain persuasive evidence to support their audit judgments.[1]

Respondents failed at these basic tasks.

Respondents' misconduct tainted nearly all areas of the audit: their audit of internal control over financial reporting related to the ALLL account, their substantive audit of the ALLL

[1] Initial Decision at 26.

account, and their response to subsequently-discovered facts related to the ALLL account. As for internal controls, Respondents failed to identify or test a control that related to a key risk point that they themselves identified – that collateral would be overvalued at the time of the year-end 2008 financial statements. As for substantive testing, Respondents essentially passed on any real scrutiny of TierOne's collateral valuation decisions, allowing any appraisal that was a year old or less to pass as "current" despite precipitous market declines, and failing to gather competent evidence to justify TierOne's repeated use of stale appraisals. And finally, when Respondents discovered appraisals that existed prior to their audit opinion, that reflected material declines in collateral value, and that TierOne had not used in its year-end 2008 valuation calculations, Respondents took absolutely no action to assess whether any of the losses those appraisals revealed should have been recorded as of year-end 2008.

Rather than defending the audit that is reflected in the audit work papers, Respondents repeatedly insisted at the hearing that they had performed significant additional audit test work, but simply had not documented it. Respondents advanced these arguments despite acknowledging the basic audit standard that an auditor must document his work. Far from excusing their improper professional conduct, this relentless focus on undocumented considerations and procedures highlights how inadequate the audit reflected in the work papers was; it "underscores the deficiency of the procedures as documented."[2] It further demonstrates either a fundamental misunderstanding of, or complete disregard for, the basic role and responsibilities of an auditor.

Considering all of Respondents' conduct, it is clear that they violated Rule 102(e). Specifically, Respondents engaged in a single instance of highly unreasonable conduct in an area where heightened scrutiny was required, or, in the alternative, multiple instances of unreasonable

[2] Initial Decision at 31.

conduct that indicate a lack of competence to practice before the Commission. See Rule 102(e)(1)(iv)(B)(1)-(2). In sum, Respondents

> knew that heightened scrutiny was warranted over the ALLL in general and the FAS 114 portion in particular, collateral overvaluation was a specific risk point, and management continued to rely on older or undiscounted appraisals from the first half of 2008 or earlier at year-end 2008, despite contrary market information. Numerous red flags indicated that management was inept and had an incentive to understate losses. Yet, their procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates failed to sufficiently address these issues, and KPMG issued a clean audit opinion.[3]

Despite finding serious violations of the professional standards, the Initial Decision imposed only limited remedial sanctions. Specifically, the Initial Decision suspended Respondent Aesoph from the privilege of practicing before the Commission for one year, and denied Respondent Bennett that privilege for six months. Given Respondents' conduct, more significant sanctions are appropriate. Respondents repeatedly violated the most basic professional standards – exercising due professional care, employing professional skepticism, and gathering competent evidence. They did so in one of the most critical and high-risk areas of the audit and in the face of glaring red flags. And even now, Respondents do not recognize their misconduct, resting their defense on claims of undocumented audit procedures despite conceding that auditors are required to document their work. On these facts, a longer suspension is called for to both protect the investing public and encourage more rigorous compliance with professional standards. At the conclusion of the hearing, the Division requested a three-year suspension for Respondent Aesoph and a two-year suspension for Respondent Bennett. Such multi-year sanctions are commensurate with Respondents' misconduct; the Commission should impose them here.

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[3] Initial Decision at 36.

II. FACTS[4]

A. Background on TierOne and its High Risk Loan Portfolio

Respondents Aesoph and Bennett were the engagement partner and senior manager, respectively, on the audit of TierOne's 2008 financial statements. [I.D. 1, 6.][5] Although TierOne was a regional bank that had historically focused on its primary market area of Nebraska, Iowa, and Kansas, in the mid-2000's TierOne aggressively expanded its lending activities by opening loan production offices ("LPOs") in then-booming markets, including Nevada, Arizona, and Florida. [I.D. 4.] The primary purpose of the LPOs was to originate loans for large construction and land-development projects. [I.D. 4.] Over time, TierOne increased its portfolio of these high-risk loans. [I.D. 4.] The promise of the LPOs faded, however, as the Great Recession set in and many LPO markets saw record real estate value declines. [I.D. at 14.] As the real estate markets plummeted, TierOne closed its LPOs, but was left with a significant amount of these high-risk loans on its books. [I.D. 4.] By year-end 2008 – the time of Respondents' audit – TierOne had a total net loan portfolio of approximately $2.8 billion, with a quarter of its loans concentrated in the LPO markets. [I.D. 4.]

Losses on these loans were recorded through TierOne's ALLL. The ALLL is a balance-sheet reserve account intended to cover known and inherent losses in a bank's loan portfolio.

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[4] The Division's appeal is focused solely on the question of whether, given the law judge's findings of fact and conclusions of law regarding Respondents' violations of Rule 102(e), more significant sanctions are warranted. The Division recognizes that Respondents have challenged many of these findings and conclusions, and will address Respondents' arguments – both factual and legal – in its opposition to Respondents' opening briefs. For purposes of the Division's appeal, the Division presumes the law judge's findings of fact and conclusions of law on all issues other than sanctions are correct. For this reason, citations are generally to the findings and conclusions of the Initial Decision, rather than the underlying evidentiary record.

[5] References to the Initial Decision are cited as "I.D. __." Exhibits from the hearing are cited as "Div. Ex. __" for the Division's exhibits, and "Resp. Ex. __" for the Respondents' exhibits. References to the hearing transcript are cited as "T. __."

[I.D. 7.] The ALLL has essentially two components: losses related to impaired loans evaluated under FAS 114 and losses related to unimpaired loans evaluated under Statement of Financial Accounting Standards No. 5 ("FAS 5"). [I.D. 7.] At issue in this matter are the FAS 114 impaired loan losses. [I.D. 7.]

TierOne's FAS 114 impaired loans included many of the loans generated by the failed LPOs. Indeed, over 80% of the collateral underlying TierOne's impaired loans was located in the LPO markets. [I.D. 14.] Those loans were particularly concentrated in Nevada: in terms of total loan balance, Nevada loans accounted for over half of the loans reviewed for impairment. [I.D. 14.] At year-end 2008, TierOne reported $185.9 million in impaired loans. [I.D. 9.]

By both nature and circumstance, these FAS 114 impaired loans were one of the highest-risk areas at the bank. By definition, a loan is only deemed "impaired" when it is troubled: based on current information and events, it is probable that the lender will be unable to collect all amounts due according to the loan's terms. [I.D. 8; see also Resp. Ex. 44 (FAS 114) ¶ 8.] Further, TierOne's FAS 114 loans were collateral-dependent, meaning that repayment was expected from the eventual sale of the underlying collateral (e.g., the construction or land development project that the loan was intended to fund). [I.D. 8-9.] Again, much of this collateral was located in LPO states experiencing significant real estate value declines.

Collateral values drove losses on the FAS 114 loans. [I.D. 9] TierOne estimated the ALLL for its FAS 114 loans on a loan-by-loan basis, and prepared an individual FAS 114 template for each outstanding lending relationship. [I.D. 8.] It calculated the ALLL for each FAS 114 loan by comparing the estimated fair value of the underlying collateral (with some adjustments for cost and time to sell) to the book value of the loan, meaning that if the collateral value fell below the book value, losses would result. [I.D. 8.] Because TierOne used appraisals to

determine the estimated fair value of the collateral, if the appraisals overvalued the collateral, losses on the loans risked being understated. [I.D. 8.]

By the time of Respondents' audit, that risk was manifest. At year-end 2008, TierOne determined the fair value of the collateral on many of its FAS 114 loans using stale appraisals from the first half of 2008 or earlier. [I.D. 17.] It did so despite the precipitous real estate market declines of the Great Recession: there were declines from quarter to quarter during 2008; the second half of the year was economically worse than the first half; and the declines were especially pronounced in the LPO markets, with "record" market declines in Nevada, Arizona, and Florida. [I.D. 14.] Moreover, TierOne rarely discounted the appraisals to account for market conditions. [I.D. 17.]

Further underscoring the risks in TierOne's ALLL account, shortly before the 2008 audit, TierOne's primary federal regulator, the Office of Thrift Supervision ("OTS"), issued a damning examination report. [I.D. 4, 9-10.] That report made apparent the troubled state of TierOne's loan portfolio and the bank itself. [I.D. 9] It found, for example, that:

- TierOne's board and management were "exceptionally poor" in their performance, and had breached their fiduciary duty to exercise the highest standard of care in the conduct, management, and oversight of bank affairs;
- TierOne had relinquished oversight and control of its Las Vegas LPO – the source of a significant number of FAS 114 loans – to a regional construction manager, resulting in an environment "defined by reckless, high-risk lending activities and a blatant disregard for prudent credit administration procedures," which was only fueled by a compensation package that rewarded the regional manager for "production and pre-approved extensions of credit with no consideration of loan performance and asset quality";

- Credit underwriting practices were "deficient" and credit administration practices "inept";
- TierOne's "deteriorating financial condition" was principally the result of poorly administered concentrations of high-risk loans in rapidly flagging markets that were previously hotbeds for lending activity – i.e., the LPO markets;
- TierOne's concentration in construction, land, and land development loans accounted for the largest share of loss provisions, and the large investment in loans backed by collateral in declining real estate markets (like southwest Florida and Nevada) exacerbated those losses; and
- TierOne had collateral-dependent loans with stale appraisals, unsupported appraisals, and even no appraisals at all.

[I.D. 4, 9 & n.11; see also Div. Ex. 81 at 2-3, 11, 17, 23.]

As a result of its examination, the OTS downgraded TierOne from its highest rating to its second lowest. [I.D. 10.] That rating indicated TierOne had "unsafe and unsound" practices or conditions, serious financial or managerial deficiencies, and a distinct possibility of failure if the identified problems persisted. [I.D. 10 & n.13.] The OTS also increased TierOne's regulatory capital ratio requirements, the breach of which could lead to significant enforcement actions. [I.D. 10.] These capital ratio requirements were directly impacted by additional loan losses: if TierOne recorded more losses, its ratios would go down, bringing the bank closer to breach. [I.D. 10.] At the time of the audit, TierOne stood just tenths of a percent above the required ratios. [I.D. 10.]

Although, as detailed below, Respondents were acutely aware of the risks related to the FAS 114 portion of the ALLL, they issued an unqualified opinion of TierOne's 2008

consolidated financial statements and the effectiveness of its internal control over financial reporting. [I.D. 5, 11.] However, just a few months after their audit opinion, when TierOne finally obtained updated appraisals, it disclosed a staggering $120 million in additional loan losses. [I.D. 5.] In June 2010, the OTS closed TierOne. [I.D. 5.] KPMG also withdrew its audit opinion, finding that TierOne's year-end 2008 financial statements contained material misstatements related to the bank's loan loss reserves, and that TierOne had a material weakness in its internal controls. [I.D. 5.]

B. Respondents Conceded That the FAS 114 Portion of the ALLL was a High-Risk, Individually Material Area of the Audit.

Both in their audit and at the hearing, Respondents conceded the significant risks associated with the ALLL. Specifically, the ALLL was the only balance sheet account with a high inherent risk of error and a risk of fraud (meaning that TierOne might intentionally understate the ALLL). [I.D. 11 & n.14.] Indeed, Respondent Aesoph specifically conceded that, in light of the critical OTS report and the increased capital ratios, TierOne had an incentive to understate its loan losses. [I.D. 12.]

Respondents also expressly recognized the risks surrounding the FAS 114 portion of the ALLL. Respondents acknowledged that the FAS 114 portion of the ALLL was a significant estimate, had a high risk of error and fraud, and was individually material to TierOne's financial statements. [I.D. 11-12.] Significantly, Respondents recognized that using stale appraisals to value collateral was a risk associated with the ALLL, and that the risk of collateral overvaluation directly impacted FAS 114 loans. [I.D. 13.] Respondent Aesoph perhaps summed it up best when he acknowledged:

> KPMG needed to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, the FAS 114 portion of the ALLL, in order to gain reasonable assurance that the ALLL was not misstated at year-end, and

> failing to do either would mean that KPMG did not have a reasonable basis for its audit opinion.

[I.D. 12; see also Tr. 1799-1801.]

In light of these facts, it is indisputable that "[t]he ALLL was one of TierOne's most critical accounts," and that "[i]n particular, the FAS 114 portion of the ALLL was individually material to the audit and had a significant risk of material misstatement." [I.D. 26.] Further, "[c]ollateral overvaluation and the use of stale appraisals was a specific, identified risk point," and

> [s]uch risks were underscored by TierOne's loan portfolio problems, management oversight, and other red flags as set forth in the OTS report and known by Respondents; the real estate market collapse in LPO States with a significant portion of impaired loans; and TierOne's weak financial condition which, as Respondents were aware, increased pressure on management to understate losses.

[I.D. 26.] This "convergence of risk and materiality" compelled a "heightened importance for Respondents to exercise professional skepticism, corroborate management representations, and perform extensive audit procedures and obtain persuasive evidence to support their audit judgments." [I.D. 26.] Respondents failed in these tasks.

C. Respondents Repeatedly Failed to Competently Audit the FAS 114 Portion of the ALLL.

Respondents violated professional standards in three specific areas related to the FAS 114 portion of the ALLL: their audit of internal control over financial reporting; their substantive audit test work over the account; and their post-audit procedures following the discovery of new appraisals. In brief, despite the dire warnings in the OTS report and the plummeting real estate market values, Respondents did not test or question in any serious way TierOne's collateral valuations that were routinely based on stale, undiscounted appraisals. As a result of these

violations, Respondents engaged in improper professional conduct within the meaning of Rule 102(e).

1. Respondents' Failures in Testing Internal Controls.

Respondents' audit over internal controls essentially ignored the critical risk – one that they themselves identified – that TierOne was using stale appraisals to value collateral on its FAS 114 loans. In order to opine that a company's internal controls are effective – which Respondents did here – an auditor must obtain sufficient competent evidence to get reasonable assurance about whether material weaknesses exist in those controls. [I.D. 26-27; see also AS No. 5 ¶ 3.] Risk assessment drives the process, including determining significant accounts, selecting controls to test, and assessing the evidence needed for a given control. [I.D. 27; see also AS No. 5 ¶ 10.] In short, "[t]he auditor should focus more of his or her attention on the areas of highest risk." [I.D. 27; see also AS No. 5 ¶ 11.]

The FAS 114 portion of the ALLL was just such a high-risk area. As noted above, Respondents specifically identified the risk of collateral overvaluation as directly impacting the FAS 114 loans. But the control Respondents selected for testing simply did not address that risk.

Respondents identified "Appraisal Review" as the control addressing the risk of collateral overvaluation. [I.D. 13, 28.] However, on its face, the control had nothing to do with the risk. The purpose of the control was to assess whether TierOne obtained and reviewed appraisals when loans were originated, not whether those appraisals were still current or reasonable at year-end 2008. [I.D. 13, 28.] Nor did any of the other ALLL-related controls sufficiently address this risk of collateral overvaluation. [I.D. 13, 28.] In sum, "[g]iven the risks of error and fraud and that the FAS 114 portion of the ALLL was a significant estimate, the failure to obtain competent,

persuasive evidence related to whether TierOne's internal controls addressed the risk of collateral overvaluation fell short of the professional standards…." [I.D. 28.]

In addition, given the lack of a sufficient control addressing this serious risk, there was an indication of a material weakness in TierOne's internal controls: there was "a reasonable possibility that as a result of collateral overvaluation on FAS 114 loans, material misstatements regarding TierOne's reserve estimates and other financial statement assertions affected by recognized losses on FAS 114 loans would not be timely prevented or detected." [I.D. 28; see also AS No. 5, App. A, ¶ A7.] As a result, Respondents lacked a reasonable basis to conclude that no material weaknesses existed or to issue an unqualified opinion regarding the effectiveness of TierOne's internal control over financial reporting, further violating the professional standards. [I.D. 28.] Put simply, Respondents failed to comply with professional standards in their audit of internal controls. [I.D. 28.]

2. Respondents' Failures in the Substantive Evaluation of the FAS 114 Portion of the ALLL.

Respondents also fell short of professional standards in their substantive testing of the FAS 114 portion of the ALLL by failing to give any real scrutiny to TierOne's repeated reliance on stale appraisals in the face of historic real estate market declines. An auditor is charged with obtaining sufficient competent evidence to provide reasonable assurance that management's estimates and fair value measurements (such as those affecting the FAS 114 portion of the ALLL) are in conformity with Generally Accepted Accounting Principles. [I.D. 29; see also AU § 328.03, .04.] Auditors must specifically consider whether management's assumptions are reasonable and reflect, or at least are not inconsistent with, market information. [I.D. 29-30; see also AU § 328.26, .29, .36.] When management's estimate is based on a valuation, such as an appraisal, that is dated prior to the financial reporting date, "'the auditor obtains evidence that

management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the [appraisal] and the reporting date.'" [I.D. 29 (quoting AU § 328.25).] And of course, the auditor's work must be guided by the basic audit standards requiring due professional care, appropriate professional skepticism, and the need to gather sufficient competent evidence – standards which are all the more important in areas presenting significant risks. [I.D. 24-25; see also AU §§ 150.02, 230.07, 312.17, 316.27, 326.01.] To that end, while representations of management are part of the audit evidence, "'they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.'" [I.D. 25 (quoting AU § 333.02).]

Respondents' substantive audit work violated these standards. Respondents were fully aware of the of the deteriorating market conditions in 2008 [I.D. 14, 30], and of course also knew that if TierOne's appraisals on FAS 114 loans overvalued the collateral, loan losses might be understated [see, e.g., I.D. 13]. Respondents were also well aware of the pressure on management to understate those losses. [I.D. 26.] And, as discussed above, TierOne calculated the losses on many of its FAS 114 loans using stale, undiscounted appraisals from early in 2008 or before. [I.D. 17.] However, the audit work papers do not reveal TierOne's rationale for not applying discounts to the stale appraisals. [I.D. 31.] Nor, at the hearing, could Respondents point to loan-specific evidence or any documented procedures to support these decisions to rely on stale appraisals in light of precipitously deteriorating market conditions. [I.D. 31.]

Further underscoring the problems with the audit, Respondents' audit work papers categorically deemed any appraisal "current" so long as it was "within the past twelve months." [I.D. 15, 31.] This definition was plainly inconsistent with the 2008 economic climate, particularly in markets like Nevada where the FAS 114 loans were concentrated. [I.D. 14, 15.] In

addition, the definition was inconsistent with TierOne's own representations on how it viewed appraisals. [I.D. 15, 31.] For example, TierOne's lending policy provided that "in a rapidly ... deteriorating market," an appraisal value may be valid "for only a few months." [I.D. 15.] Similarly, in TierOne' ALLL memo that was included in the audit work papers, TierOne noted that it would estimate collateral values on certain Nevada loans by "discounting appraised values older than six months" – a policy that Respondents knew TierOne did not consistently follow.[6] [I.D. 15-16, 19.] Finally, even for those appraisals older than a year, the audit work papers noted only that Respondents would "inquire[ ]" about management's discounting decision. [I.D. 14 ("[I]f the appraisals were not within the past twelve months, KPMG inquired whether a discount was applied to the appraised value and, if not, inquired why TierOne did not think a discount was necessary or appropriate."); see also I.D. 31.]

The baseless definition of a year-old appraisal as "current" was not the only instance of the audit work papers ignoring market conditions. In assessing test work done throughout 2008, the work papers stated that "market conditions have not materially deteriorated" since the prior period reviews. [I.D. 15, 31.] At the hearing, Respondents could not explain their workpaper statement. [I.D. 15, 31.] Indeed, Respondents admitted the statement made no sense given the continued decline throughout 2008, and Respondent Aesoph belatedly disavowed it. [I.D. 15, 31.]

Respondents' procedures fell well short of professional standards. [I.D. 31.] As the law judge summarized, Respondents

> failed to obtain sufficient competent evidence to support their audit judgments regarding TierOne's estimates, and the work papers do not reflect the due care and professional skepticism required of this high risk and material area of the audit.... In the context of the financial statements taken as a whole, the FAS 114

[6] Despite this statement, many of the Nevada FAS 114 loans were assessed using appraisals older than six months with no discount applied. [See I.D. 17.]

> portion was critical to those statements and required heightened scrutiny.... Respondents' failure to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, management's estimates meant that they did not have a reasonable basis for their audit judgments.

[I.D. 31-32.]

3. Respondents' Failures in Assessing Subsequent Discovery of Appraisals

The final category of audit failures involved Respondents' response – or lack thereof – to their discovery, after the audit, of appraisals that might have affected their audit report. Auditing standards outline procedures that "'should be followed by the auditor who, subsequent to the date of the [audit] report..., becomes aware that facts <u>may have existed</u> at that date which <u>might have affected</u> the report...." [I.D. 34 (quoting AU § 561.01) (emphasis added).] These standards were triggered following the 2008 audit, but Respondents took no action.

Shortly after the Respondents issued their audit report in March 2009, they discovered appraisals dated January and February 2009 that affected two FAS 114 loans in Nevada. [I.D. 20, 34.] At year-end 2008 (and thus the time of Respondents' March 2009 audit report), TierOne was estimating losses on these loans using stale appraisals rather than the new appraisals. [I.D. 20, 34-35.] What's more, the new appraisals revealed significant declines in the collateral value estimates used at year-end 2008: 29% and 40%, respectively. [I.D. 20.] The new appraisals resulted in $3.6 million in new loss provisions, which TierOne recorded in the first quarter of 2009. [I.D. 20, 34] At least a portion of this collateral deterioration (and losses) occurred in 2008, and therefore related to TierOne's year-end financial statements. [I.D. 35.]

Despite this, Respondents performed absolutely no evaluation under AU § 561. [I.D. 20, 35.] This was concerning not only because the new appraisals cast doubt on the valuations of these two loans, but because they called into question TierOne's rampant practice of using of stale appraisals: "Under the circumstances of this case and given the risk of collateral

overvaluation, the new appraisals cast doubt on the collateral values that TierOne used at year-end 2008, given that numerous loans, particularly in Nevada, were also valued using older or undiscounted appraisals from the first half of 2008 or earlier, despite contrary market information." [I.D. 35.] In short, Respondents were required to conduct further inquiry and investigation, and that their failure to do so violated professional standards. [I.D. 35.]

D. Respondents' Defenses Do Not Excuse – and Indeed Exacerbate – Their Audit Failures.

Rather than acknowledge any misconduct, or even defend the audit that appears in their work papers, Respondents instead offer their uncorroborated testimony that the audit work papers were wrong and that they in fact performed additional, but undocumented, audit procedures. Not only does this "defense" fail to explain or excuse the inadequate audit, it demonstrates that Respondents fail to grasp the basic rules that govern auditor conduct.

As a threshold matter, Respondents' argument runs directly contrary to core professional standards: "PCAOB standards ... require that auditors '<u>must document</u> the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions,' and such '[a]udit documentation <u>must clearly demonstrate</u> that the work was in fact performed.'" [I.D. 25 (quoting AS No. 3 ¶ 6).] Indeed, Respondents testified to their awareness of the audit documentation standards, and to their importance. [I.D. 11.] Respondent Aesoph testified that he expected the audit engagement team to document, and believed they did document, the evidence used in arriving at their audit judgments. [I.D. 11; <u>see also</u> Tr. 1763-64.] And Respondent Bennett unequivocally testified that, as to the work the engagement team did to test TierOne's process for evaluating FAS 114 loans, "<u>[a]ll of that work got documented</u>." [Tr. 713-14; <u>see also</u> I.D. 11.] But despite the clarity of the audit standards and Respondent's own

testimony, Respondents repeatedly claimed at the hearing that they did significant audit work that simply was not documented. These claims are, simply put, incredible.

For example, Respondents' insisted that they based their conclusion that TierOne's FAS 114 estimates were reasonable on their understanding and analysis of FAS 157's standards on fair value measurements, despite the wholesale absence of any reference to FAS 157 in the relevant audit workpapers. More specifically, Respondents argued that, because the 2008 real estate market included a large amount of foreclosures and other "distressed" sales, market pricing indices and appraisals in that time period were not reflective of "fair value" in the context of GAAP. [I.D. 18, 32.] The law judge properly saw this argument for the red herring that it was:

> The weight of the evidence casts doubt on Respondents' contention that either their or management's proffered interpretation of FAS 157 – i.e., that appraisals and market information were less indicative of fair value due to increased distressed sales and/or foreclosures in 2008 – played any meaningful role in their assessment of TierOne's fair value estimates.

[I.D. 18 (emphasis added).]

The evidence that Respondents did not consider FAS 157 in their audit of the FAS 114 loans was overwhelming. For example, as the law judge specifically noted, "[t]here is no reference, in either the memo or templates, to FAS 157." [I.D. 18.] Perhaps even more telling, KPMG had a separate work paper on FAS 157 (in a separate section of the work papers), and that work paper, "which Bennett reviewed, does not reference FAS 114 or the ALLL in its inventory of significant accounts and disclosures accounted for under that standard." [I.D. 18.] Further exposing the incredible nature of Respondents' argument that FAS 157 informed them that market indices or appraisals were not appropriate measures of fair value are the facts that:

- "There is no evidence that TierOne adjusted, or that the auditors recommended adjusting, an appraisal because of concerns the appraisal did not reflect fair value;

instead, TierOne continued to use appraisals to estimate fair value in 2008 through early 2009";

- "During the audit, KPMG recommended that TierOne update appraisals to continue to value the loans";
- "In prior investigative testimony, Bennett stated that a current appraisal was the best indicator of fair value"; and
- "Notably, Respondents conceded that in reviewing market data to assess management's estimates, they did not consult indices that removed, nor performed any analysis to remove, distressed sales from the data."

[I.D. at 19.] At bottom, "[t]he record belies Respondents' assertion that, in evaluating TierOne's FAS 114 estimates, they conducted any sort of review consistent with their proffered interpretation of FAS 157." [I.D. 33.]

Respondents also argued that they reviewed information from "loan files" in evaluating the FAS 114 loans. [I.D. 18, 32.] Respondents insisted such a review occurred even though it was not documented, even though Respondent Bennett acknowledged that he could have documented such a review, and even though other work papers (on other topics) did, in fact, document a loan file review. [I.D. 18.] In addition to the fact that the purported loan file review was not documented, "the work papers do not reveal, and Respondents fail[ed] to point to, any information in those 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." [I.D. 32.]

Respondents' final purported – but undocumented – procedure was a claim that, in response to TierOne's failure to discount appraisals, Respondents had a conversation with

TierOne's controller in which he explained that the total annual "charge-offs" on impaired loans in Nevada approximated the annual market declines. [I.D. 19, 33.] Respondents claim that this conversation, which they purportedly corroborated, was key to their audit conclusions. [I.D. 19.] Once again, however, that conversation and the purported corroborating procedures are not documented anywhere in the work papers. [I.D. 19, 33.] What's more, any happened consistency between total annual charge-offs and overall market declines does not amount to sufficient audit evidence. [I.D. 19, 33.]

In sum, Respondents' significant focus on this undocumented work at the hearing did not excuse their deficient audit, it instead highlighted their disregard for professional standards. Indeed, the law judge emphasized that Respondents' continued attempts to distance themselves from the work papers by pointing to undocumented considerations and procedures "underscores the deficiency of the procedures as documented." [I.D. 31.]

E. Respondents Violated Rule 102(e).

In light of their serial violations of professional standards, it is clear that Respondents violated Rule 102(e). Respondents' course of conduct represented a single instance of highly unreasonable conduct and, in the alternative, repeated instances of unreasonable conduct that indicate a lack of competence to practice before the Commission. [I.D. 36; see also Rule 102(e)(1)(iv)(B)(1), (2).] Specifically, Respondents

> knew that heightened scrutiny was warranted over the ALLL in general and the FAS 114 portion in particular, collateral overvaluation was a specific risk point, and management continued to rely on older or undiscounted appraisals from the first half of 2008 or earlier at year-end 2008, despite contrary market information. Numerous red flags indicated that management was inept and had an incentive to understate losses. Yet, their procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates failed to sufficiently address these issues, and KPMG issued a clean audit opinion.

[I.D. 36.] This finding was sound, well-reasoned, and justified by the evidence.

After finding Respondents' repeated violations of professional standards violated Rule 102(e), the law judge assessed sanctions. The law judge properly concluded that both Respondents should be denied the privilege of practicing or appearing before the Commission for some period of time. [I.D. 36-37.] However, the law judge imposed only a one-year suspension on Respondent Aesoph and a six-month suspension on Respondent Bennett. In light of their significant failures, more significant sanctions arerequired.

III. DISCUSSION

Violation of Rule 102(e) is a serious matter. The rule was adopted "as a means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence." Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, 57,165 (Oct. 26, 1998). Indeed, the rule "has been the primary tool available to the Commission to preserve the integrity of its processes and ensure the competence of the professionals who appear and practice before it." Michael C. Pattison, CPA, 104 S.E.C. Docket 2559, 2012 WL 4320146, *5 (2012). Thus, in determining the appropriate sanctions, the Commission is to be mindful of the remedial nature of the rule as well as the purpose in the rule's promulgation: "to ensure that the Commission's 'processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process.'" Gregory M. Dearlove, CPA, 92 S.E.C. Docket 1427, 2008 WL 281105, *30 (2008) (quoting Amendment to Rule 102(e), 63 Fed. Reg. at 57,164).

The Commission is also guided by the Steadman public interest factors – the egregiousness of the conduct, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of assurance against future violations, the recognition of the

wrongful nature of the conduct, and the likelihood of future violations – as well as the need for deterrence in determining the appropriate sanction. See, e.g. Steven Altman, Esq., 99 S.E.C. Docket 2744, 2010 WL 5092725, *19 (2010) (citing Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981)). In sum, sanctions under Rule 102(e), while not punitive, are intended to protect the investing public and encourage more rigorous compliance with professional standards. See, e.g., McCurdy v. SEC, 396 F.3d 1258, 1264-65 (D.C. Cir. 2005).

At the conclusion of the hearing below, the Division requested a three-year suspension for Respondent Aesoph and a two-year suspension for Respondent Bennett. Such sanctions properly recognize the serious nature of Respondents' misconduct, and appropriately account for their respective roles. These significant sanctions are warranted here.

A. Auditor Competence is of Paramount Importance.

The Commission has long recognized the importance auditors play in our financial markets. As the Commission noted when amending Rule 102(e) to its current form:

> Accurate financial reporting is the bedrock of our capital markets. Accountants play a vital role in assuring issuers compliance with reporting requirements. The Commission wishes to underscore the importance of that role and the need for accountants to comply with the standards of conduct applicable to members of their profession. These professional standards include the overarching requirement that auditors exercise due care in their audit of a company's financial statements.

Amendment to Rule 102(e), 63 Fed. Reg. at 57,164-65. The Commission went on to underscore the critical role auditors play in protecting the investing public:

> Investors have come to rely on the accuracy of the financial statements of public companies when making investment decisions. Because the Commission has limited resources, it cannot closely scrutinize every financial statement. Consequently, the Commission must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements. In short, both the Commission and the investing public rely heavily on accountants

> to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information.

Id. at 57,175; see also McCurdy, 396 F.3d at 1261 ("Investor confidence is bolstered by the knowledge that public financial statements have been subjected to the rigors of independent and objective investigation and analysis.").

The Commission has also emphasized that it is not just intentional misconduct by an auditor that is cause for concern. Rather, "[t]he Commission believes that a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive." Amendment to Rule 102(e), 63 Fed. Reg. at 57,167. For that reason, negligent conduct – either a single instance of highly unreasonable conduct, or multiple instances of unreasonable conduct – can be as egregious a disciplinary matter as intentional or reckless conduct. See Dearlove, 2008 WL 281105 at *30 (imposing four-year suspension for multiple instances of unreasonable conduct). This is just such a case. Respondents' audit failures, while negligent and not intentional, represent a serious threat to the Commission's processes.

B. Respondents' Audit Failures Were Significant, and a Strong Sanction is in the Public Interest.

Respondents' misconduct occurred in one of the highest-risk areas of the audit. Respondents were repeatedly confronted with red flags, including the OTS report, which noted management's ineptitude, TierOne's troubled state, and potentially dire issues with TierOne's loan portfolio. Despite this, Respondents repeatedly failed to follow basic professional standards of due care, professional skepticism, and securing competent audit evidence. Notably, even now, Respondents do not recognize their improper conduct, instead continuing to attempt to justify their audit by pointing to numerous undocumented procedures they purportedly performed, despite acknowledging the bedrock auditing principle that audit work must be documented. For all of these reasons, significant remedial sanctions are justified.

1. Respondents' Failures in One of the Most Critical and High-Risk Areas of the Audit Were Egregious.

The Commission considers the egregiousness of the misconduct when assessing the appropriate sanction. See, e.g. Altman, 2010 WL 5092725, at *19. As a threshold matter, the ALLL was "critical to the portrayal of [TierOne's] financial condition and a significant focus of the audit." [I.D. 8.] More specifically, the FAS 114 portion of the ALLL "had a high risk of error and fraud," and was itself individually material. [I.D. 11-12; see also I.D. 12 (noting that Respondent Aesoph conceded that if KPMG failed to perform sufficient audit procedures and obtain persuasive evidence regarding the FAS 114 portion of the ALLL, KPMG did not have a reasonable basis for its audit opinion).] Respondents explicitly recognized that possible overvaluation of collateral and the use of stale appraisals – issues at the heart of this case – were risks associated with the ALLL. [I.D. 26.] These risks were underscored by other red flags – including the OTS report's findings, the real estate market collapse, and TierOne's weakened financial condition and increased regulatory capital ratios, "which, as Respondents were aware, increased pressure on management to understate losses." [I.D. 26.] In light of these extraordinary risks, Respondents themselves conceded that there was a "heightened importance under professional standards to exercise professional skepticism, corroborate management representations, and perform more extensive audit procedures and obtain more persuasive evidence." [I.D. 11.]

Despite their acknowledgement of these risks, Respondents failed to adhere to even the most basic standards of auditing. For example, when substantively testing the FAS 114 portion of the ALLL, Respondents' audit work papers deemed an appraisal "current," and did no further assessment of whether the appraisal's value was still reasonable, so long as the appraisal was dated some time during 2008. [I.D. 31.] Such a definition was inconsistent with both TierOne's

stated policies (which provided that an appraisal may only be valid for a few months in a rapidly deteriorating market, and promised to apply discounts to appraisals in certain markets that were more than six months old) and with the 2008 economic climate (which saw significant market deterioration that only accelerated during the second half of the year). [See I.D. 14-15, 30.] Respondents' work papers even included the inexplicable claim that "market conditions have not materially deteriorated" since the time of the quarterly reviews throughout 2008. [I.D. 15, 31.] Further, TierOne's rationale for not discounting appraisals from the first half of 2008 or earlier was largely undocumented, and Respondents could not identify evidence or procedures to support the decisions not to discount in light of the deteriorating market conditions. [I.D. 31.] Finally, the work papers noted that even for those appraisals not deemed "current" (i.e., those that were older than a year), the auditors would only "inquire" about management's discounting decisions – a step that is insufficient, standing alone, to form a reasonable basis for an audit opinion. [I.D. 31.] See also AU § 333.02 ("[R]epresentations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."); Russell Ponce, 73 S.E.C. Docket 358, 2000 WL 1232986, *10 (2000) ("[D]ue care is not exercised if the auditor fails to corroborate representations of client management that are significant to the financial statements."). In short, Respondents failed to exercise due care. They failed to exercise appropriate professional skepticism. They failed to obtain sufficient competent evidence. These were violations of the most "fundamental principles of auditing," Dearlove, 2008 WL 281105, at *30, and represent significant audit failures.

The egregiousness of Respondents' conduct is only exacerbated by their continued insistence that they performed important, undocumented procedures that – they claim – save

their deficient audit. PCAOB standards plainly require that auditors "must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." AS No. 3 ¶ 6. Such "[a]udit documentation must clearly demonstrate that the work was in fact performed." Id.; see also id. ¶ A.26 ("Auditors have an unconditional requirement to document their work."). While auditors have discretion in how and to what extent they document, more extensive documentation is needed in higher-risk areas and areas, like estimates, that require greater judgment – precisely the characteristics of the FAS 114 portion of the ALLL at issue in this case. See id. ¶ 7.

Despite acknowledging the importance of these audit documentation standards, Respondents repeatedly return to multiple undocumented procedures to justify their conduct. [See, e.g., I.D. 11, 18-20, 32-33.] They did so at the hearing, in their post-trial briefs, and even in their petition for review of the Initial Decision. Incredibly, Respondents make these arguments despite testifying that all of the work the engagement team did surrounding the FAS 114 portion of the ALLL was documented. [I.D. 11.] Respondents continued reliance on undocumented audit procedures further demonstrates the egregiousness of their misconduct and their failure to recognize or respect the basic principles of professional conduct.[7]

2. Respondents' Failures In Several Areas of the Audit Were Recurrent.

The Commission also considers whether misconduct was isolated or recurrent. See, e.g. Altman, 2010 WL 5092725, at *19. Respondents' failures flowed through the audit, from the testing of internal control over financial reporting, to the substantive testing of the FAS 114 portion of the ALLL, to the assessment of newly-discovered appraisals after the audit opinion was issued. [I.D. 28 (finding Respondents did not have a reasonable basis to issue an unqualified

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[7] In addition to not being documented, the procedures would not have cured the deficiencies in the audit. [See I.D. 32-33.]

opinion on TierOne's internal controls, and did not comply with professional standards when testing internal controls), 30-32 (finding Respondents failed to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, management's estimates on the FAS 114 portion of the ALLL), 34-35 (finding Respondents violated AU § 561 by failing to appropriately assess newly-discovered appraisals).] Despite identifying the significant risks relating to, and the critical importance of, the FAS 114 portion of the ALLL, Respondents violated professional standards nearly every time they performed audit work over that account. These repeated failures call for significant sanctions.

3. Respondents' Continued Employment with KPMG Presents an Opportunity for Future Violations.

The Commission also considers the "likelihood that [a respondent's] occupation will present opportunities for future violations." Steadman, 603 F.2d at 1140. See, e.g. Altman, 2010 WL 5092725, at *19. That risk plainly exists here. As a threshold matter, "'the existence of a violation raises an inference that it will be repeated.'" Wendy McNeeley, CPA, 105 S.E.C. Docket 655, 2012 WL 6457291, at *18 (quoting Geiger v. SEC, 363 F.3d 481, 489 (D.C. Cir. 2004)). Further, Respondents remain employed as auditors at KPMG, and they have provided no assurances that they do not intend to audit public companies in the future. See, e.g., Resp. Jt. Prop. Findings of Fact and Conclusions of Law ¶¶ 1 (Aesoph is still an audit partner at KPMG); 14 (Aesoph continues to believe the audit complied with professional standards); 23 (Bennett was involved in 10-12 audits since the 2008 TierOne audit); see also Tr. 1525 (Bennett remains a senior manager at KPMG). For all of these reasons, there is a likelihood that Respondents' occupations could lead to future violations.

4. Respondents' Continued Attempts to Justify their Conduct Demonstrate That They Have Made No Assurances Against Future Violations.

Finally, and importantly, the Commission considers whether a respondent has recognized the wrongful nature of his conduct and sincerely assured it will not happen again. See, e.g. Altman, 2010 WL 5092725, at *19. Here, Respondents have done just the opposite. Throughout the hearing, the post-hearing briefing, and even the petitions for Commission review of the Initial Decision, Respondents have insisted that their audit procedures were not only adequate, but exemplary. See, e.g., Respondent Bennett's Petition for Review at 2 (claiming Bennett "went above and beyond in performing the audit"); Resp. Jt. Prop. Findings of Fact and Conclusions of Law ¶ 14 (Aesoph continues to believe he complied with all professional standards).

Perhaps most troubling, as discussed in detail above, Respondents continue to rely heavily on claims that they performed significant audit procedures that are simply not documented in the audit work papers. They do so despite the clear guidance in the PCAOB standards that auditors must document their work. Their arguments go well beyond mounting a "vigorous defense" to the Division's charges; they demonstrate a fundamental misunderstanding of basic auditing standards and raise serious concerns about whether Respondents will repeat their misconduct in the future. See, e.g., McNeeley, 2012 WL 6457291, *18 (2012) ("While a respondent has the right to present a vigorous defense, [respondent's] testimony and subsequent arguments on appeal reflect a continuing failure to grasp the role of an auditor.").[8] Under all of these circumstances, Respondents have neither recognized the wrongful nature of their conduct nor made any credible assurance against future violations.

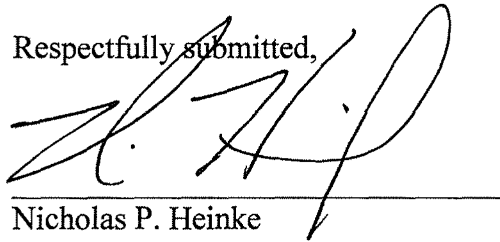
[8] Indeed, prior to the TierOne audit, Respondent Aesoph had been given less than satisfactory ratings on two audits for poor audit documentation. See Div. Ex. 109.

IV. CONCLUSION

Respondents violated basic professional standards in nearly all aspects of their audit of the FAS 114 portion of TierOne's ALLL account, ignoring glaring red flags and employing no real scrutiny to one of the highest-risk areas of the audit. Further, they continue to demonstrate a disregard for professional standards by focusing their defense on undocumented audit procedures. Respondents' misconduct calls for sanctions greater than those imposed in the Initial Decision.

Dated: October 24, 2014

Respectfully submitted,



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