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ADMINISTRATIVE PROCEEDING

File No. 3-15168

In the Matter of

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

Respondents.

OPENING BRIEF OF RESPONDENT JOHN J. AESOPH

October 24, 2014

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I. EXECUTIVE SUMMARY

The Initial Decision ("Decision") censures Mr. Aesoph for his work as the engagement partner on the 2008 year-end audit of TierOne Corporation ("TierOne" or "Bank"), the holding company of a moderately sized regional bank based in Lincoln, Nebraska. The Decision finds Mr. Aesoph's audit work in one particular area—impaired loan loss estimates—was so deficient as to constitute a threat to the Commission's processes sufficient to warrant a one-year temporary suspension. While the Decision is objectionable on many grounds, its incorrect reasoning and analysis nearly all flow from a fundamental misconception of fair value accounting under Generally Accepted Accounting Principles ("GAAP").[1]

The Decision assumes TierOne should have recorded additional losses in the second half of 2008 on impaired loans in certain markets hit particularly hard by the financial crisis. As the Decision emphasizes, deteriorating economic conditions in 2008 led to record real estate market price declines, particularly in states such as Nevada, Arizona, and Florida, where collateral securing many of TierOne's impaired real estate loans was located. Market prices in those areas declined throughout 2008, most precipitously in the last half of the year. While TierOne continued to record losses in the second half of 2008 in those markets, it did not record additional losses on particular loans. The Decision found this troubling and sanctioned Mr. Aesoph for his purported failure to resolve what the ALJ perceived as a discrepancy between

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[1] Fair value is defined by FAS 157 as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." (J.F.P. ¶ 55) (quoting FAS 157 ¶ 5). "An orderly transaction . . . is not a forced transaction (for example, a forced liquidation or distress sale)." *Id.* (quoting FAS 157 ¶ 7).

market conditions and recorded loan losses at year-end 2008. But there was no discrepancy and therefore no cause for additional audit procedures.

The presumed discrepancy results from the ALJ's failure to apply GAAP, a failure that taints the Decision's entire analysis. Under GAAP—specifically Statement of Financial Accounting Standards No. 114, Impaired Loans ("FAS 114")—banks are required to record as a loss (either as an amount "charged-off" or an amount recorded in the allowance for loan loss) the difference between the outstanding balance of an impaired loan and management's estimate of the fair value (not the market value) of collateral securing the loan. FAS 114 expressly notes that Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157") applies to estimates of fair value of collateral. FAS 157 makes clear that forced transactions—such as foreclosures—are not determinative of fair value. While market price indices in certain markets, such as Nevada, showed continued decline in the last half of 2008, those indices included a significant number of foreclosure transactions. Indeed, in late September 2008, the SEC Office of Chief Accountant ("OCA") and Financial Accounting Standards Board ("FASB") released a clarifying statement, reminding issuers that forced transactions are not determinative of fair value. Management concluded at year-end that the increasing frequency of foreclosure prices in Nevada in the latter half of 2008 was not determinative of a change in fair value of the collateral securing its impaired loans.

Mr. Aesoph and his audit team conducted extensive audit procedures related to impaired loans and related internal controls at each quarter in 2008 and at year-end: they collected and reviewed each impaired loan loss worksheet; compared individual estimates to documentation in the loan files (including appraisals, property inspection reports, and periodic loan analyses); tested controls related to the relevant financial statement assertion (the Allowance for Loan

Losses, "ALLL"); assessed the overall impaired loan portfolio and related trends; and considered the estimates in light of third-party market analyses. Mr. Aesoph confronted management specifically about the last half of 2008; he found that management had recorded additional impaired loan losses in the third and fourth quarters of 2008 and that over the course of the year, management recorded an approximate 30% loss in the value of its Nevada impaired loan portfolio. Far from failing to investigate, Mr. Aesoph critically assessed management's loss estimates in light of the audit evidence and the loan loss and fair value accounting standards. And when Mr. Aesoph signed the 2008 audit opinion, he had sufficient audit evidence to support his professional judgment that TierOne's impaired loan loss estimates were reasonably stated at year-end.

The concept of fair value accounting is at the heart of the audit procedures challenged, and yet the Decision ignores FAS 157 in its analysis of Mr. Aesoph's conduct and professional judgments, dismissing it as having been raised merely "in defense." ID at 3. Mr. Aesoph, however, was not at liberty to ignore relevant GAAP during the 2008 audit. Nor did he, as was evidenced by numerous references to fair value in the work papers and his uncontradicted testimony. The Decision has created a literal double-standard. In September 2008, the OCA emphasized that foreclosure prices are not determinative of fair value and yet now, six years later, a dedicated accounting professional has been temporarily suspended for following that guidance. Punishing an auditor for following the only fair value guidance OCA saw fit to release during the crisis is the height of unfairness. This cannot stand.

The Decision's further failure to weigh any of Respondents' evidence or expert testimony makes its conclusions all the more concerning. To read the Decision, it is as if no hearing ever occurred. For example, not once in its 39 pages does the Decision contend with Respondents'

expert's testimony—an auditor currently on the Auditing Standards Board with decades of experience auditing regional banks—that in her opinion, Mr. Aesoph appropriately applied GAAP and complied with all professional audit standards. The Decision incorrectly interprets the audit documentation standard as an evidentiary mechanism for dispensing with evidence and argument inconsistent with its conclusions. Indeed, the Decision fails to weigh the substantial, uncontroverted record evidence that Mr. Aesoph did his job.

In meting out the penalty, the Decision ignores entirely that Mr. Aesoph was willfully deceived by TierOne management and that it was Mr. Aesoph—not the OTS or any other person outside KPMG—who took immediate action upon learning of potential inconsistencies in management's representations. Indeed, both the Department of Justice and the Commission have charged central figures in TierOne management with misleading the auditors, which resulted in settled proceedings and a guilty plea by TierOne's Chief Credit Officer. Moreover, Mr. Aesoph has cooperated and will continue to cooperate with those government investigations. None of these factors, including the critical importance of the OCA/FASB 2008 guidance, appears to have been considered by the Decision.

In addition, the Decision erroneously interprets the relevant audit and accounting standards, fails to weigh the evidence, erroneously admits the expert report and testimony of a wholly unqualified witness, and wrongfully imposes severe sanctions against two auditors in a case lacking any evidence of unreasonable conduct (much less "highly unreasonable" conduct or "repeated instances" of unreasonable conduct). The Decision's analysis not only fails to apply appropriately Rule 102(e); its many errors deprive Mr. Aesoph of his right to due process and violate the Administrative Procedure Act ("APA").

The Decision potentially has ended the public accounting career of Mr. Aesoph, a diligent professional who has served as a well-respected and highly competent auditor, leader, and mentor since beginning his public accounting career in 1996. (J.P.F. ¶¶ 1-15.[2]) Any initial decision denying a public accountant the privilege of appearing or practicing before the Commission, even temporarily and for a period of one year, is enough to place in serious jeopardy that accountant's career—such is the practical (if unintended) consequence of a Rule 102(e) sanction. Indeed, Mr. Aesoph has essentially already been penalized for an extended period, as he has not audited a public company since the Commission instituted proceedings in January 2013. In evaluating the Decision and whether Rule 102(e) has been satisfied, the Commission must keep in mind that the stakes are nothing short of Mr. Aesoph's livelihood. And never before has the Commission ended the career of a public accountant under facts and circumstances such as those presented here. The administrative process employed here, particularly juxtaposed against the resulting deprivation of livelihood, places in serious doubt the fairness and constitutionality of the entire proceeding.

II. BACKGROUND

Mr. Aesoph is an audit partner with KPMG LLP and 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.) Historically a regional bank with operations in Nebraska, Iowa, and Kansas, TierOne opened Loan Production Offices ("LPOs") in additional markets in the mid-2000s. (J.P.F. ¶ 114.) LPOs focused on originating construction and land development loans in

[2] 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 where necessary.

rapidly developing markets secured by collateral in states ultimately hit hard by the financial crisis, including Nevada, Arizona, and Florida. (*Id.*) At year-end 2008, TierOne's loan portfolio totaled $2.8 billion with a $63.2 million reserved for ALLL. (J.P.F. ¶ 117.) The year-end gross impaired loan balance was $226 million, of which approximately one-quarter—$57 million—was recorded as a loss over the year ($40.4 million charged-off, and $16.4 million reserved in ALLL). (J.P.F. ¶ 121.)

TierOne's impaired loans were "collateral dependent" under FAS 114, meaning the Bank expected to recoup its investment through the sale of real estate collateral. (J.P.F. ¶ 52.) As required by FAS 114, the Bank measured loan impairment based on the fair value of the collateral, charging off the difference between the loan's book value and the estimated collateral fair value, and recording an ALLL reserve that included offsets for estimated selling costs and a further discount for the estimated time to sell, usually a full year. (J.P.F. ¶¶ 52, 225, 321.)

Given the developing distress in real estate markets, Mr. Aesoph increased and intensified the audit and quarterly review procedures. (ID at 12; J.P.F. ¶ 180.) As a result, the team recorded a 50% increase in hours over 2007, and the increase was largely attributed to procedures over loan losses and related internal controls. (J.P.F. ¶ 180.) Mr. Aesoph's own hours increased by more than 35% over the prior year, with nearly all hours spent on-site at TierOne. (J.P.F. ¶¶ 9, 181.) The audit team's expanded procedures included the engagement of a KPMG credit specialist to assess critical elements of TierOne's loan loss estimation process, including a consideration of TierOne's FAS 114 methodology. (J.P.F. ¶¶ 183, 191.) Mr. Aesoph also oversaw a thorough evaluation of regulatory actions taken by the Office of Thrift Supervision ("OTS") in 2008, engaging regulatory experts to assess the regulatory activity and its impact. (J.P.F. ¶¶ 190, 194, 198-204.)

When Mr. Aesoph signed the 2008 TierOne audit opinion, he and his team had performed extensive audit procedures related to management's loan loss estimates. Those procedures allowed the auditors reasonably to conclude that TierOne's impairment and valuation process functioned appropriately throughout 2008, despite the volatility in several of the loan portfolio's markets. (J.P.F. ¶ 268.) They saw that the ALLL was determined based on the particular markets observed and the extent of dislocation within each market. (J.P.F. ¶¶ 310, 394.) The audit team's significant conclusions and evidence supporting those conclusions were documented in loan and related internal control work papers reviewed not only by Mr. Aesoph, but also by the Concurring Review Partner and a member of KPMG's National Office. (J.P.F. ¶¶ 33, 359-60, 440.)

In assessing the ALLL and impaired loan losses, Mr. Aesoph and his team reviewed a wide body of evidence, almost all of which is ignored by the Decision. For instance, at each quarter and at year-end, the auditors reviewed management's process for estimating the ALLL, including identifying impaired loans and measuring estimated loss. (J.P.F. ¶¶ 253, 313.) They reviewed each FAS 114 template the company prepared for its impaired loans and used the information regarding discounts taken and fair value estimated as a starting point for other procedures. (J.P.F. ¶ 322.) They collected extensive loan file documentation, particularly in Nevada, which included appraisals, property inspection reports, periodic loan and credit reviews, and borrower correspondence. (J.P.F. ¶¶ 335, 340, 361, 385.) They assessed the bank's written analysis of each of its individual markets, and they obtained the third-party reports—including market price indices like Case Shiller—for relevant markets. (J.P.F. ¶¶ 310-12, 315-16.) They reviewed TierOne's documentation of its internal controls related to the financial assertion and obtained extensive materials in testing key controls. (J.P.F. ¶¶ 278-80, 285-86, 290, 302.)

The auditors took particular note of the Nevada and Arizona impaired loans, where foreclosures increasingly dominated the market toward the last half of the year. (J.P.F. ¶¶ 368-69.) The auditors noted that management recorded significant estimated losses in the first half of 2008. Each loan's documented fair value analysis shown in the FAS 114 templates included a significant carrying discount given management's assessment that it would take a year or more to sell the collateral due to expected illiquid market conditions in the subsequent period. In effect, there was no "undiscounted appraisal" because each impaired loan, at each quarter and at year-end, carried a time-value discount. (Resp'ts Ex. 42, Johnigan Report at 53-54.) The auditors knew management anticipated an illiquid period in determining the collateral fair value, particularly beginning at second quarter end and continuing throughout the last half of 2008. By year-end, the auditors observed that the company continued its process of identifying impaired loans and measuring and recording loss estimates; there was no indication management sought to avoid recording losses, as it recorded another $36.4 million in provision expense and charge-offs in the second half of 2008. (J.P.F. ¶ 386.) But by year-end 2008, and particularly given the OCA/FASB guidance in late September 2008, the auditors recognized the Nevada and Arizona markets—and therefore applicable market price indices—were dominated by forced transactions and therefore yielded pricing not determinative of fair value under FAS 157. (J.P.F. ¶¶ 371, 374, 381.)

At year-end 2008 the auditors saw in TierOne a bank that had aggressively addressed its loan loss reserves and its underlying loan portfolio. They noted that TierOne had, in mid-2008, closed its LPOs and, prior to that time had discontinued making real property loans in those markets. (J.P.F. ¶ 115.) Under the guidance of the OTS, TierOne had, in the first half of 2008, changed its calculation of loan losses, moving such losses directly to charge-offs, rather than to

reserves. (J.P.F. ¶ 197.) They saw that TierOne, in the second half of 2008, had engaged an outside expert firm to assist internal audit in a loan review that included all loans exceeding one million dollars in its portfolio, including impaired loans; the auditors reviewed a summary of the results of that review and TierOne's measures to address them. (J.P.F. ¶ 216.c.) Similarly, they learned that TierOne had increased its internal controls, had created additional review procedures for its loan classification process, and had both its Controller and, separately, its Asset Classification Committee ("ACC") conduct reviews of its impaired loan portfolio. (J.P.F. ¶¶ 212, 216, 277.) Taking note of the significance of the recent enactment of FAS 157 and the September 2008 OCA/FASB guidance, the auditors reviewed TierOne's extensive disclosure in its 2008 10-K of its FAS 157 methodology and the nature of its loan loss estimates under that guidance. (J.P.F. ¶¶ 119, 389.) Observing those several measures, the auditors reviewed TierOne's loan loss discounts by market and noted that in distressed markets like Nevada the loan losses recorded (approximately 30% in 2008) was analogous to market indices that were, in several respects, more inclusive of losses than was necessary under the FAS 157 methodology. (J.P.F. ¶ 376.)

III. THE INITIAL DECISION IS FATALLY FLAWED

The Rules of Practice provide that the Commission may "affirm, reverse, modify, set aside, or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record." Rule 411(a). The ALJ committed prejudicial errors during the course of the proceeding, made findings and conclusions of fact that were clearly erroneous, and reached erroneous conclusions of law.

The Decision erroneously interprets or altogether ignores the most relevant GAAP and audit standards, disregards the accounting experts' opinions and instead substitutes the ALJ's

own subjective hindsight judgment for the auditors'. The Decision effectively and retroactively rewrites audit and accounting standards to support the charges against Mr. Aesoph. As a result, not only is the Decision without foundation in fact or law, it violates the fundamental tenet in Rule 102(e) cases that hindsight not be used to evaluate auditor conduct. *See* Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, 57,168 (Oct. 26, 1998).

In addition, the Decision fails to consider the appropriate relevant evidence in reaching its conclusions. 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." *Id.* §§ 556(d), 557(c)(3)(A).

The Decision further fails to comply with the APA's requirement that the agency consider "the 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 SEC LEXIS 1114, at *8 (Mar. 27, 2014). On technical matters the Division must produce "expert testimony . . . or other authoritative evidence." *Id.*

Due process similarly requires the agency to 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 & Finishing Sch., 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 for N.Y. v. Fed. Power Comm'n*, 511 F.2d 338, 345 (D.C. Cir. 1975)).

Here, the Decision does not consider the evidence on both sides—it perfunctorily adopts the Division's view and dismisses without even considering Mr. Aesoph's evidence on the auditors' application of key audit and accounting standards. And, while the Division's view of the evidence in isolation may appear persuasive as described in the Decision, it is insubstantial and inadequate when the complete story and all the evidence are considered, including the testimony and reports of Respondents' experts and points where the Division's experts agreed. Further, the Decision's retroactive application of novel—and incorrect—interpretations of the relevant standards has deprived Mr. Aesoph of fair notice, subjected him to unduly vague and subjective standards of conduct, and constitutes impermissible rulemaking by enforcement.

The Decision's errors, alone and in combination, violate the APA and Mr. Aesoph's right to basic fairness and due process. Accordingly, the Commission should reverse the Decision.

A. The Decision Erroneously Interprets Relevant Professional Standards and Is Unsupported by the Record

The Decision's interpretation and application of relevant provisions of professional guidance contradict the plain language of that guidance and depart from the opinions of the audit

and accounting experts who testified in this case. Each of these errors, as well as the ALJ's failure to appropriately consider the relevant evidence, necessitates reversal.

i. The ALJ's Erroneous Interpretation of FAS 157 Results in a Decision that Ignores the Entirety of the Audit Work and Evidence Obtained

An ALJ is bound to apply professional audit and accounting standards applicable to a financial statement audit at the time of the challenged audit. 63 Fed. Reg. 57,164, 57,168. The Decision fails even to consider, let alone apply, two concepts under FAS 157. First, FAS 157 expressly excludes "forced transactions" from the definition of fair value. (J.P.F. ¶ 55.) Prices paid in forced transactions, such as foreclosures, do not represent fair value under GAAP. (J.P.F. ¶¶ 56-57.) Yet the Decision faults Mr. Aesoph for purportedly failing to square the Bank's substantial write-downs with further declines in market prices in the latter half of 2008—declines that both sides' experts largely attributed to foreclosures and forced transactions. ID at 19-20. Second, TierOne's impaired loan loss estimates, as disclosed in the 10-K, were based on the least precise level of estimates described under FAS 157—"Level 3 inputs." (J.P.F. ¶¶ 61, 63, 118.) Level 3 inputs are, by definition, "unobservable," and "reflect the entity's own assumptions about the assumptions market participants would use in pricing the asset" given the "best information available in the circumstances." (J.P.F. ¶ 63.) In failing to appreciate the Level 3 inputs for what they were—"unobservable"—the Decision overlooks that there was no more precise audit evidence to be had; that the auditors' objective instead was to gather available evidence to assess reasonableness of the impaired loan loss estimates in the context of the financial statements taken as a whole. (J.P.F. ¶¶ 78-79, 234.) That is precisely what Mr. Aesoph and his team did.

a. The Decision Applies an Incorrect Interpretation of Fair Value

The 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 Division's own audit expert, 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. (Tr. 1236:22-1237:15.) He conceded that "auditors and others were struggling with how to apply [FAS] 157 in markets where you had deteriorating conditions." (J.P.F. ¶ 480.) The Decision's refusal to contend with applicable GAAP causes it to misunderstand Mr. Aesoph's responsibilities and professional judgments.

The Decision faults Mr. Aesoph for failing to ensure collateral valuations reflected market declines from the second half of 2008. ID at 33 n.36. This reasoning brings into focus the Decision's confusion as to applicable GAAP in a critical area of the audit. As part of a set of comprehensive audit procedures, Mr. Aesoph appropriately considered market data. However, the raw market price indices cited by the Division were heavily influenced by the type of "disorderly transactions" that must be excluded from consideration under FAS 157. (J.P.F. ¶¶ 503-04.) Even Professor Thakor, the Division's economist, admitted that the indices were influenced by a staggering proportion of distressed sales. (J.P.F. ¶¶ 516-17.) Those indices were therefore not determinative of a change in fair value. (J.P.F. ¶¶ 153-55.)

On this point, the timely release of the September 2008 joint OCA/FASB guidance served as a significant touchstone for the TierOne audit. Issued at the height of the financial crisis, when "the current environment . . . made questions surrounding the determination of fair value particularly challenging," it sent a clear message: market prices, if infected with distressed sales, are not determinative of fair value. (J.P.F. ¶¶ 58, 520-21.) Mr. Aesoph and his team were

fully aware of the market distress owing to the economic upheaval, particularly its significance for TierOne markets like Nevada. (J.P.F. ¶¶ 4, 355-56, 362-63, 371.) In these circumstances, the auditors considered the indices not as substitutes for individual fair value estimates but as additional data points providing a level of assurance that management's impaired loan losses appeared reasonable. (J.P.F. ¶¶ 374, 376.) Indeed, the auditors understood that the declines in the market price indices for areas like Nevada and Arizona actually *overstated* declines in fair values. (J.P.F. ¶¶ 150, 154, 157, 376.) Because TierOne's impaired loan losses were similar in magnitude to even *unadjusted* indices, the overall loss recognition numbers provided assurance that TierOne's loss estimates for the entire year ended 2008 were not unreasonably low. (J.P.F. ¶ 376.)

Indeed, Mr. Kellogg pointed to these same statistics in response to Messrs. Aesoph and Bennett's year-end inquiry as to why TierOne had not recorded additional losses on certain impaired loans in the second half of 2008. (J.P.F. ¶ 372.) He noted that TierOne had recorded losses of approximately 30% overall in 2008 on its Nevada portfolio of impaired loans, a number consistent with the 33% decline in raw market prices reported by publicly-available market indices. (J.P.F. ¶¶ 372, 376, 402.) As Respondents' Exhibit 259 (attached to the brief as Exhibit B) illustrates, the losses TierOne recorded on its impaired Nevada loans track the decline in the Case-Shiller market index closely—an index that included distressed sales and therefore overstated fair value declines.

The Decision's use of reference points such as "significant real estate declines," "decreasing real estate values," and "significant decline in total sales and sale prices," illustrates its refusal to recognize the GAAP definition of fair value. *See* ID at 13-14, 17, 29-30. It faults Mr. Aesoph for relying on supposedly undiscounted appraisals from the first two quarters of

2008 despite "contrary market information" at year-end.[3] *Id.* at 36. But that is the very point the Decision fails to grasp: first, price declines caused by foreclosure and other forced sales in the latter half of 2008 are not—according to FAS 157 and the Staff's own guidance—determinative of a change in fair value. (J.P.F. ¶¶ 155, 381.) Second, the "contrary market information" to which the Decision alludes is not, within the meaning of FAS 157, contrary information at all. Third, every impaired loan FAS 114 calculation and worksheet included an estimated discount for time to sell. (J.P.F. ¶ 321.)

b. The Decision Fails to Consider Evidence Supporting the Auditors' Assessments Under FAS 157

By misunderstanding the professional standards, the Decision ignores an entire body of evidence Mr. Aesoph and the engagement team considered in assessing the reasonableness of TierOne's ALLL estimation process and management's collateral fair value estimates. These audit procedures provided Mr. Aesoph and the engagement team a comprehensive view of management's ALLL estimation process and included (1) testing controls relevant to the FAS 114 portion of the ALLL (*see* Section III.A.iv, *infra*); (2) gaining an understanding of the impairment determination (J.P.F. ¶¶ 252-56, 262-66); (3) assessing the reasonableness of the FAS 114 methodology (J.P.F. ¶ 352); (4) understanding and testing the assumptions applied to each individual FAS 114 calculation, such as selling costs and number of months to sell (J.P.F. ¶ 321); (5) reviewing all FAS 114 templates and subjecting many to testing and corroboration based on the loan files (J.P.F. ¶ 322); (6) testing management's ALLL calculations, both at the level of the ALLL as a whole and at the individual loan level (J.P.F. ¶¶ 322, 389); and

[3] In doing so, the Decision is improperly influenced by Professor Thakor's opinions, an expert who was not qualified to opine on accounting matters.

(7) analyzing trends and the overall loss recognition to obtain assurance that the outcome of the FAS 114 estimation process was reasonable (J.P.F. ¶¶ 372-76, 402, 412).

Based on the full audit record, Mr. Aesoph concluded that TierOne's ALLL estimation process was reasonable and that TierOne considered each individual impaired loan and the market in which that collateral was located in estimating its fair value. (J.P.F. ¶¶ 360-61.) Given the extent of these procedures, the Decision's contention that "[i]t is *undisputed* that TierOne did not consistently follow" its "[policy of trying] to estimate collateral value declines in real estate by discounting appraised values, which are older than six months" is unsupported, erroneous, and led the Decision to an incorrect conclusion. ID at 19 (emphasis added). The Decision's description of TierOne's estimation process as a "policy" is, in and of itself, a clear error when the text itself is reviewed. In fact, the text expresses TierOne's concern that appraisals in foreclosure markets more closely resemble fire sale estimates and not fair value. (J.P.F. ¶¶ 368-69.) Equally in error is the Decision's misinterpretation of GAAP to find a discrepancy between market prices and management's estimates, despite then-current accounting standards and Staff pronouncements that explicitly require the exclusion of prices paid in disorderly transactions. (ID at 30-33; J.P.F. ¶¶ 55-59.)

Moreover, as the audit evidence showed, the Bank did follow its estimation methodology. For loan valuations the Division challenges as "not discounted," TierOne recognized losses during 2008 of 26% and applied discounts to five of the twelve Nevada impaired loans with appraisals older than six months. (J.P.F. ¶¶ 366, 386; Resp'ts Ex. 42, Johnigan Report at 148.) The other appraisals were dated largely in the second quarter of 2008, when the markets were more stable compared to year-end 2008. (J.P.F. ¶¶ 366, 371.) Messrs. Aesoph and Bennett also documented management's initiative in impairing over $40 million in loans not yet 90 days past

due (loans typically accrued until 90 days past due). (J.P.F. ¶ 404.) In the second half of 2008, TierOne continued to evaluate its impaired loan portfolio on a loan-by-loan basis. (J.P.F. ¶ 412.) In this period, the Bank identified 17 additional loans as newly impaired (including a $17 million Nevada lending relationship in the fourth quarter), took an additional charge-off of $19.4 million on impaired loans (partially attributable to additional discounts taken on Nevada collateral with appraisals from 2006), and obtained 26 new appraisals, largely in markets more orderly than Nevada and hence more likely to be indicative of fair value. (J.P.F. ¶¶ 323, 386.)

However, in declining markets—like Nevada in the second half of 2008—it was reasonable to use appraisals obtained at a time when the market was relatively more stable, and this is precisely what the auditors observed. (J.P.F. ¶¶ 371, 507.) The auditors concluded that it was "not unreasonable" for TierOne to use 2008 appraisals obtained when markets were more orderly to value loans after markets had become extremely disorderly, particularly where management also assumed the carrying period for many of those loans would be 12 or even 36 months. (J.P.F. ¶ 376.) Furthermore, the Bank did not rely solely on these early 2008 appraisals to evaluate collateral at year-end; Mr. Aesoph observed that process included interim credit reviews of the status and fair value of the loans' collateral. (J.P.F. ¶ 385.) The engagement team obtained these interim credit reviews, along with other audit evidence from the loan file, including listing prices, construction progress reports and market analyses. (J.P.F. ¶¶ 344-46, 385.)

The Decision dismisses the 30% loss figure as "not necessarily pertain[ing] to market declines in [2008] alone." ID at 33 & n.36. There is no support for this conclusion, and the uncontroverted evidence proves otherwise. The 30% loss recorded on Nevada impaired loans with collateral deficiencies in 2008 *excluded* losses booked in 2007. (J.P.F. ¶ 477; Resp'ts Ex.

42, Johnigan Report at 145.) As Ms. Johnigan, Respondents' audit expert, explained, it would be highly inappropriate to assume that losses recorded in 2008 arose in some prior period and explained her report's analysis demonstrating the same. (*Id.*) And Mr. Barron, the Division's expert, conceded that Ms. Johnigan's analysis showed the exclusion of 2007 losses. (Tr. 1145:2-1146:18.) The Decision ignores this evidence.

Rather than consider the totality of this audit evidence and work paper documentation, the Decision improperly elevates the import of one particular sentence in a single two-page work paper to the exclusion of all contrary evidence. It finds that the description of the audit work in the two-page summary of the FAS 114 procedures "shows that Respondents did not sufficiently assess TierOne's collateral valuation decisions." ID at 14-16, 31. The Decision relies on a particular line in the memo that states "market conditions have not materially deteriorated since the time of our loan review procedures during the year and thus the year-end valuations appear reasonable." *Id.* at 15. Mr. Aesoph testified that this sentence did not belong in the memo, did not reflect what he was seeing in the market in 2008, and was not indicative of the audit procedures or their findings. (Tr. 838:22-841:1.)

The documentation of the FAS 114-related audit procedures was not limited to a single errant sentence in one two-page work paper. Mr. Aesoph considered *all* of the audit procedures and *all* of the resulting evidentiary matter, and the full body of impaired loan and allowance work papers makes clear that the auditors appreciated the increasing market turbulence throughout 2008. (J.P.F. ¶¶ 163-64, 356 (citing work papers documenting downturn in banking sector due to "delinquencies in the housing and real estate markets," "current economic trends and continuing deterioration in TierOne's loan portfolio," documenting trend in non-performing

loans, charge-offs, and provisions, and noting the "continued deterioration in real estate values and financial markets in general").)

In the same vein, the Decision concludes that the record "belies" the auditors' assertion that FAS 157 informed their conclusions regarding the audit solely because the term "FAS 157" is not referenced in the auditors' FAS 114 memo or the FAS 114 templates. ID at 18-19, 32-33. But, as all the auditors testified at trial, FAS 157 is synonymous with "fair value." (J.P.F. ¶¶ 61, 376; Tr. 1771:5-23 (Aesoph); Tr. 2242:16-43:11 (Barron).) And despite the fact that the term "fair value" or "FV" appears repeatedly throughout the "Loans" work paper series, the Decision instead points to a single memorandum addressing FAS 157 that "does not reference FAS 114 or the ALLL"—but it appears in a completely different section of the work papers that does not address the loan portfolio. ID at 18 (citing Resp'ts Ex. 4 at KPMGTO 4027-30). Yet on that basis, the Decision concludes that the auditors must not have considered FAS 157 when performing their audit of the impaired loan losses.

The error in the Decision's reasoning on this point is made obvious when placed in the context of the full audit record and testimony. For example, over the course of their investigative testimony, Messrs. Aesoph and Bennett referenced "fair value" more than 125 and 200 times respectively. (J.P.F. ¶ 106.) The loan loss memorandum management provided the auditors to explain its loss estimation process demonstrates that management applied the FAS 157 definition of fair value in challenging markets. (J.P.F. ¶ 376.) And the evidence shows that the audit team tied TierOne's extensive FAS 157 10-K disclosures to the audit work on TierOne's impaired loans. (J.P.F. ¶¶ 118-19, 230 (Note 22 in the 10-K Disclosure includes tickmark tying the FAS 157 disclosure back to the impaired loan work paper at L-37).)

The record shows that Mr. Aesoph and his team appropriately considered all aspects of GAAP pertaining to fair value, including the critically-important fair value guidance issued by OCA in late 2008. (J.P.F. ¶¶ 119, 381.) The Decision's finding regarding the auditors' consideration of FAS 157 is not supported by the applicable standards or the evidence, and the Decision must be reversed.

ii. The Decision's Application of AS No. 3 as an Exclusionary Rule of Evidence Is Erroneous and Undermines the Decision's Entire Analysis

Using AS No. 3 as an exclusionary rule of evidence, as the Decision has done here, is an inappropriate use of the standard. AS No. 3 requires auditors to employ professional judgment in developing the audit documentation. (J.P.F. ¶ 108.) While "audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement . . . [t]o understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached," the particular content and wording of the documentation for any given audit is a matter of professional judgment. (J.P.F. ¶¶ 107-09, 432-33.)

AS No. 3 does not require auditors to document every piece of evidence reviewed or conversation had because such a requirement would be impractical—removing professional judgment from auditors—and would be tantamount to establishing an evidentiary rule, which the PCAOB specifically has rejected and which cannot be undone through enforcement. (J.P.F. ¶¶ 109, 432; AS No. 3 App. ¶¶ A21-A24.) Further, nothing in AS No. 3 requires all procedures relating to a financial statement assertion to be documented in a single work paper. (J.P.F. ¶¶ 432-33.)

Instead, an auditor's choice to document particular procedures and evidence—using what specific language and where—are matters of professional judgment. (J.P.F. ¶¶ 432-33.) "An

objective of this standard is to ensure that auditors give proper consideration to the need to document procedures performed, evidence obtained, and conclusions reached *in light of time and cost considerations* in completing an engagement." (J.P.F. ¶ 432.) The sufficiency of documentation under AS No. 3 is assessed from the standpoint of "an experienced auditor" with "a reasonable understanding of audit activities." (Resp'ts Ex. 49, AS No. 3 ¶ 6.) 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." (*Id.*) The ALJ is not an "experienced auditor" who has "studied the company's industry" and relevant "accounting and auditing issues," and at the least, the ALJ should have considered and weighed the testimony of the expert witnesses.

The Decision fails to acknowledge that documentation is a matter of professional judgment and instead uses the standard improperly to exclude Respondents' evidence. In its AS No. 3 analysis titled "Undocumented Procedures," the Decision sweeps aside Respondents' arguments and extensive evidence regarding their procedures and considerations: FAS 157, the 30% loss recognition TierOne booked on Nevada loans in 2008, and TierOne's loan files. *See* ID at 18-20, 33. The Decision characterizes Respondents' evidence on each of these points as "undocumented," and consequently declines to consider them or the body of evidence surrounding them.

This finding, which ignores the auditors' procedures on FAS 114 analyses for fifty-five borrower relationships and the thousands of pages of support material contained in the loan files, is factually incorrect. (J.P.F. ¶ 451.) The Decision, for example, suggests that the only evidence Respondents presented regarding TierOne's 30% Nevada loan loss recognition was their testimony that "they had a conversation with Kellogg," TierOne's Controller, and "related

procedures"—neither of which were documented, according to the Decision.[4] ID at 19. But the fact that TierOne recorded a 30% loss on Nevada impaired loans was plainly evident in the Bank's records included in the work papers. (J.P.F. ¶ 373.) The Impaired Loans schedule, at work paper series L-37, presents an analysis of loan losses by geographic market and shows that TierOne recorded significant losses of roughly 30% on Nevada impaired loans in 2008. (J.P.F. ¶¶ 377-78.) The Division's own audit expert, Mr. Barron, admitted that the calculation showing the 30% loan loss recorded could easily be performed based on the data in the L-37 work paper series. (*Id.*) And the Respondent's expert, Ms. Johnigan, did just that—relying solely on information in the work papers—and precisely derived the 30% loss amount. (J.P.F. ¶ 379.)

The conversation with Mr. Kellogg was also documented. The L-30 work paper includes a notation regarding the engagement team's discussions with management—including Mr. Kellogg—regarding market trends and the fact that TierOne had recorded significant losses. (J.P.F. ¶¶ 371-73.) Moreover, Messrs. Aesoph and Bennett provided uncontradicted testimony that the Kellogg conversation took place, and described its particulars, including how it corroborated the 30% loss recognition. (J.P.F. ¶¶ 363, 372-80.) Yet the Decision rejects this unrebutted testimony regarding the conversation, removing from the Division the burden to prove its allegations by a preponderance of the evidence and improperly placing it on Respondents. *See* ID at 19-20; *Steadman v. SEC*, 450 U.S. 91, 96-98 (1981).

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[4] Despite the ALJ's finding that "Respondents' conversation with Kellogg and procedures as to the 30% loss recognition are not documented," the preceding paragraph in her Decision acknowledges that these "related procedures" included "calculating the 30% loss recognition based on a schedule of delinquent Nevada loans *attached to another work paper* and by consulting market data." ID at 19 (emphasis added) (citing Tr. 583-84, 1605-10; Div. Ex. 120 at 5574, 5590-91; Resp'ts Ex. 68, ALLL Memo at 55, 57-59).

AS No. 3 is a professional standard, not an evidentiary standard. AS No. 3 and its official comments clarify that the standard does not preclude other evidence of work performed, and actually contemplates that auditors may present "persuasive other evidence" that procedures were performed, evidence was obtained, and appropriate conclusions were reached. (Resp'ts Ex. 49, AS No. 3 ¶ 9; AS No. 3 App. ¶ A28.) The PCAOB has rejected any presumption that a lack of documentation may be equated with a lack of work because of concern that (1) even a rebuttable presumption might be misunderstood "to establish evidentiary rules for use in judicial and administrative proceedings," and (2) "not allowing oral explanations when there was no documentation would essentially make the presumption 'irrebuttable.'" (AS No. 3 App. ¶¶ A21-A24.)

The tone and content of these PCAOB comments are striking in their contrast with the Decision, which does exactly what the PCAOB explicitly intended to prevent. The Decision has created an irrebuttable presumption that the absence of certain documentation under AS No. 3 definitively proves that audit procedures were not performed and that Respondents therefore violated *different* audit standards—AU §§ 328 and 342—by supposedly failing to obtain "sufficient competent evidence to support their audit judgments." *See* ID at 29-32. But whether the documentation requirements were met by *preparing* adequate documentation must be analyzed separately from whether there was a failure to *obtain* sufficient competent evidence.

By conflating these issues and using AS No. 3 to exclude evidence from consideration, the Decision fails to weigh the evidence, misplaces the burden of proof on the Respondents and then precludes any consideration of the proof they have introduced, thereby violating their rights to due process. Further, to the extent the 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) absent fraud.

iii. The Decision Fails to Weigh the Expert Testimony and Reports

The Decision does not make any factual findings or conclusions regarding the expert opinions and testimony. In its 39 pages, the Decision's discussion of the four expert witnesses' testimony and opinions is confined to less than a single page. ID at 20-21. Remarkably, despite stating that the opinion would later refer to the "experts' evidence . . . as appropriate," the remaining portion of the Decision contains not a single citation to the expert reports or testimony. *Id.* at 20 n.26. The Decision fails to make any credibility determinations regarding the experts or to explain the ALJ's reliance, or her decision not to rely, on any particular expert.

The testimony of Respondents' audit expert, Sandra Johnigan, a current member of the AICPA's Auditing Standards Board with years of experience auditing financial institutions like TierOne, is never discussed—not once. For example, the Decision ignores FAS 157, concluding in part that it was one of the "procedures or considerations not documented in the work papers." *Id.* at 18. From the Decision, one would never know that Ms. Johnigan discussed the relevance of FAS 157 to the audit in both her report and testimony and referred to a portion of the L-30A work paper as "absolutely" a "recognition of the provisions of FAS 157 . . . I don't know why else they [management] would have written it." (J.P.F ¶ 376.) The Decision concludes that "the auditors' procedures to address [discounts to individual loans] are not evident from the work papers"; that they "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." ID at 31-32. Yet Ms. Johnigan's report 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.

In both her report and testimony, Ms. Johnigan explained how the Bank had effective controls in place to address the risk of collateral overvaluation. She pointed to work papers demonstrating this internal control test work and even consulted the same source materials noted in the work papers—the loan files, the ACC meeting minutes, and the ACC loan review materials. Yet the Decision concludes, without explication or acknowledgment of Ms. Johnigan's testimony or report, that "the record does not indicate that Kellogg or the ACC performed any specific procedures to effectively address collateral overvaluation." *Id.* at 13. One would never know, from reading the Decision, that Ms. Johnigan opined the engagement team's substantive and internal controls test work complied with professional standards and provided Mr. Aesoph a reasonable basis for issuing an unqualified audit opinion. (J.P.F. ¶ 303.)

On the flip side, although the Decision ignores equally the Division's audit expert, Mr. Barron, the Decision at times appears to rely on his opinions despite his significant credibility problems. In his report, Mr. Barron failed to cite or discuss the provisions of FAS 157 most relevant to this case, viz., distressed sales. (J.P.F. ¶ 479.) On cross-examination he was forced to admit the relevance of FAS 157 and its command that distressed sales cannot be considered in measuring fair value. (J.P.F. ¶ 478.) Mr. Barron ultimately conceded that "it's generally understood that forced sales or liquidation sales or distressed sales really should be excluded in trying to determine comparable sales for the determination of fair market value."

(*Id.*) Mr. Barron even testified that estimating fair value is "not simply a matter of applying a housing price index" (J.P.F. ¶ 515), yet the Division's economic expert, Professor Thakor, rejected the plain language of FAS 157 and suggested alternative collateral fair value estimation based entirely on housing price indices. He insisted that fair value should be based only on "market forces," even when the market is dominated by distressed sales. (Tr. 194:22-195:22.) The Decision appears to embrace Professor's Thakor's wholesale misstatement regarding fair value and fails completely to resolve the discrepancy in the Division's own witness testimony or weigh the evidence.

Mr. Barron had to admit certain shortcomings in his own work, such as failing to review any of the loan files on which the auditors relied. (J.P.F. ¶¶ 482-83.) He ignored the largest segment of the ALLL audit work (the FAS 5 segment) and, indeed, the substantial majority of work paper documentation, but had to acknowledge that the auditors had no such freedom; their responsibility was to reach a conclusion on the reasonableness of the ALLL as a whole. (J.P.F. ¶ 470.) Mr. Barron went even further, testifying that charge-offs "aren't really relevant," even though he admitted that recording charge-offs (such as was done by TierOne at the direction of the OTS in the first half of 2008) diminishes the ALLL amount required for a given loan. (J.P.F. ¶ 476.) As Ms. Johnigan explained, "unless you understand the charge-offs, you don't understand what's happening with the loans. You don't understand what the composition of the [loan loss] provision is and whether or not it affects the current year." (*Id.*)

The Decision lacks an appropriate evidentiary foundation because it does not appropriately consider and weigh the expert testimony. Rule 102(e) requires a comparison of the actions taken by the auditor with the actions a reasonable accountant should have taken in the same circumstances. Here, the only such evidence presented was Ms. Johnigan's testimony, and

the Decision ignores it. Further, by substituting her own opinions for the opinions and testimony of the audit experts, the ALJ violated her basic fact-finding obligations and arrived at an erroneous, unsupported decision. Commission employees such as ALJs cannot supplant the role of witnesses with expertise in accounting and auditing. *Cf. Nat'l Realty & Constr. Co. v. Occupational Safety & 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."). Audit standards are not legal rules or regulations, and they have been designed such that compliance is to be judged by a practitioner. (J.P.F. ¶¶ 74, 104, 107.) The Decision's failure to weigh or rely on expert testimony in assessing whether Mr. Aesoph's conduct complied with professional standards requires reversal.

iv. The Decision's Erroneous Interpretation of AS No. 5 Resulted in the Failure to Consider Audit Work Applicable to the Relevant Financial Statement Assertion of Loan Losses

AS No. 5 required Mr. Aesoph and his team to identify and test controls that addressed the risk of misstatement of the relevant "financial statement assertion"—the ALLL. (Resp'ts Ex. 50, AS No. 5 ¶ 28; *see also* J.P.F. ¶¶ 98-99, 102-04.) At the hearing, both Respondents and the Division understood that ALLL was the relevant financial statement assertion and the control objective was therefore to address the risk of misstatement of the ALLL. (*See, e.g.*, Tr. 490:6-9.) And, in fact, Respondents identified and tested multiple controls that addressed the risk of misstatement of the ALLL. (*See* J.P.F. ¶ 237 (citing Johnigan reiterating that the ALLL was the significant account for which the auditors were to identify key internal controls over financial reporting).) Yet the Decision mistakenly defines the control objective as "the risk associated with the reliability or validity of appraisals in valuing collateral for FAS 114 loans[,]" which is

not a financial statement assertion. *See* ID at 28. This is contrary to AS No. 5 and unsupported by the evidence presented at the hearing. AS No. 5 requires audits at the level of financial statement assertions. (Resp'ts Ex. 50 at ¶ 28.) "Appraisals" indisputably are not financial statement assertions. Evaluating internal control audit procedures from the perspective of one input to an estimation process, as the Decision has done here, rather than from the perspective of the financial statement assertion would effectively rewrite the audit standards. (J.P.F. ¶ 78.)

By erroneously defining the control objective, the Decision reaches a conclusion unsupported by the evidence because that conclusion ignores the several procedures the auditors performed in testing controls that addressed the risk of misstatement of the ALLL. The Decision's flawed reasoning primarily results from an improperly narrow focus on a single internal control titled "Appraisal Review" that the Decision relies on to conclude "there is *no evidence* that [this or other] controls sufficiently addressed the risk of collateral overvaluation at year-end." ID at 28 (emphasis added). The many other internal controls in place and evaluated by the auditors are dismissed in perfunctory fashion: "[T]he record does not indicate that [management] performed any specific procedures to effectively address collateral overvaluation." *Id.* at 13. This analysis is belied by the evidentiary record and shows a failure to consider "evidence on *both* sides." *See Landry*, 204 F.3d at 1140 (emphasis in original).

The record shows that the "Appraisal Review" control the Decision faults was just one element of a control environment that the audit team tested and that addressed the risk of overvaluation of collateral securing impaired loans. As Mr. Bennett explained, "the [Appraisal Review] control" was "focused on the front end" of the loan origination process. (J.P.F. ¶¶ 273-75.) It was not designed as a substitute for the other back-end controls that TierOne employed to review and evaluate individual FAS 114 estimates. As Ms. Johnigan elaborated in her expert

report and testimony, the appraisal review was part of a "very specific" set of controls addressing the reliability of inputs that would later be used in the FAS 114 estimation process. (J.P.F. ¶¶ 270, 273.)

Another control—which the Decision improperly ignores—was specifically designed to evaluate TierOne's loan-by-loan FAS 114 estimates and the risk that loan losses are improperly valued. (J.P.F. ¶ 244; *see also* Resp'ts Ex. 261 (a chart of FAS 114 key controls admitted into evidence before the ALJ noting "Finance Department (Controller) Reviews FAS 114 Templates," attached to the brief as Exhibit A).) The audit work papers explain the details of this control, noting that individual FAS 114 templates at TierOne were prepared in the first instance by Credit Administration personnel. (J.P.F. ¶¶ 244, 279.) Once prepared, the templates were provided to the Controller, Mr. Kellogg. (*Id.*) As the representative of the Finance Department, Mr. Kellogg was responsible for approving the FAS 114 templates and signing them as "Reviewer." (*Id.*) Utilizing this loan-by-loan review, Mr. Kellogg addressed the risk of collateral overvaluation at TierOne. (J.P.F. ¶ 280.)

Ms. Johnigan explained that Mr. Kellogg's review of individual FAS 114 templates was 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." (*Id.*) The Division's own 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 would have been an appropriate person to conduct that review. (*Id.*) Reading the Decision, one would never guess that this evidence exists in the record.

Moreover, the Decision also overlooks the significance of the ACC review of the ALLL, another key control. (J.P.F. ¶¶ 277, 281-83.) The entity at TierOne responsible for advising the Board of Directors on the adequacy of the ALLL and each underlying FAS 114, the ACC consisted of numerous key members of management, including, critically, Mr. Kellogg, who—as noted in the work papers—brought to the ACC "his knowledge of having reviewed the FAS 114 [templates] . . . and . . . the data surrounding them." (J.P.F. ¶¶ 282-84, 287.) As part of the audit team's testing of internal controls, Mr. Kellogg confirmed and the work papers document that the ACC "discusses the recent trends, status changes within the portfolios, reserve modifications, and FAS 114 impairments." (J.P.F. ¶ 284.) The auditors confirmed this description of the ACC's function by inspecting "documents and records," including minutes of the ACC's meetings and the several detailed reports the ACC reviewed in those meetings. (J.P.F. ¶ 285.) These materials included the Classification of Assets report (detailing the loan balance, risk rating, appraised value, appraisal date, and TierOne comments regarding individual impaired loans), interim credit reviews for FAS 114 loans, and troubled asset reports. (J.P.F. ¶¶ 291-98.) Mr. Bennett's notations on the ACC minutes show that the audit team considered and evaluated the ACC's review of these items as a control that addressed the adequacy of the ALLL. (J.P.F. ¶¶ 286, 291, 298.)

As Ms. Johnigan testified, these reports contained information specific to individual loans. (J.P.F. ¶ 291.) These reports, she explained, contained "enough information to get a sense of what is happening with the loan." (*Id.*) And as documented in the work papers, the meeting minutes show the ACC reviewed this detailed information to "conduct[] an Asset Review for any changes to Specific and General Reserves." (J.P.F. ¶ 288.) Only after the ACC reviewed the reports did it conclude "there would be no changes to Specific or General Reserves at this time."

(*Id.*) Combined with the expertise of Mr. Kellogg—who was "intimately aware of the 114 calculation" (J.P.F. ¶ 287)—the reports provided the ACC with information sufficient to fulfill its function and address the risk of overvaluation of loan collateral. (J.P.F. ¶ 301.) Yet none of this test work, documented in the work papers and testified to during the hearing, is evident from the Decision, which incorrectly characterizes and dismisses the ACC as conducting a "high-level review" of reports relating to the ALLL. ID at 8.

The Decision's findings and conclusions regarding internal controls do not represent a "full . . . appreciation of all of the evidence." *Cinderella*, 425 F.2d at 585 n.3. It was improper and in violation of the APA for the Decision to sanction Mr. Aesoph without considering the full record of the internal control procedures relevant to the financial statement assertion he and his team performed during the year-end 2008 audit.

v. The Decision Requires Something the Audit Standards Expressly Do Not: An Audit of Individual Loans

As with the internal controls over financial reporting, the Decision misconstrues and misapplies professional audit standards relevant to loan loss estimates. AU § 342 requires that audit procedures be directed toward the relevant financial statement assertion—here, the ALLL—in the context of the financial statements taken as a whole. Both Respondents' and Division's experts agreed on this point. (J.P.F. ¶ 78.) Yet the Decision rewrites AU § 342 to require an audit of individual loan loss estimates, contrary to both the language of that standard and the expert testimony, and ignores the fundamental role and application of professional judgment under AU § 230.

The Decision takes issue with Mr. Aesoph's assessment of TierOne's loan-by-loan "collateral valuation decisions," asserting that the auditors did not obtain sufficient audit evidence regarding discounts the Bank applied to individual real estate appraisals. ID at 30-31.

This misconstrues the role of the auditor as well as the relevant financial assertion being audited. Management has responsibility to estimate the ALLL—both with respect to individual impaired loans and as a whole. (J.P.F. ¶ 39.) In planning and performing the substantive audit procedures, Mr. Aesoph and his team were to obtain "sufficient competent evidential matter to provide reasonable assurance that" management's total ALLL estimate was "reasonable in the circumstances" (Resp'ts Ex. 61, AU § 342.07), particularly in the context of a $2.8 billion loan portfolio. (J.P.F. ¶ 117.)

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 (quoting 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 (citing 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.)

The Decision's improper application of AU § 342, § 328, and § 230 resulted in the ALJ failing to properly credit substantive audit procedures performed in 2008 to test the estimation process, and failing to credit key audit evidence indisputably obtained and reviewed, which provided reasonable assurance that the ALLL estimate was reasonable. The Decision imposes a requirement not found in the professional standards.

vi. The Record Disproves the Allegation that Appraisals Received in the First Quarter of 2009 Triggered AU § 561

The Decision concludes that Mr. Aesoph and his team violated AU § 561, relying exclusively on evidence the Division urged supported the charge: 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. ID at 35. AU § 561 calls for an auditor to perform additional procedures if the auditor "becomes aware that [1] facts may have existed at that date [date of the auditor's report] [2] which might have affected the report had he or she been aware of such facts." While the audit team received new appraisals, other evidence, which the Decision and Division ignored, contradicted the charge that these appraisals required evaluation under AU § 561. Throughout 2008, TierOne had already booked $8.7 million dollars in losses on these two particular loans, 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; Resp'ts Ex. 42, Johnigan Report at 145.) Further, as noted by Respondents' expert, another 2009 appraisal showed a $1.5 million excess collateral value over TierOne's estimate. (J.P.F. ¶ 419.) The existence of this appraisal reflecting an increase in collateral value is important not only because it significantly reduced the new appraisals' net impact, but also because no reasonable auditor would have considered the new appraisals particularly remarkable, let alone sufficient to trigger AU § 561.

The Decision also fails to acknowledge that neither Mr. Barron, the Division's audit expert, nor any other witness testified that the two new appraisals would have required a restatement of TierOne's 2008 financial statements or that the cumulative adjustments were material. (J.P.F. ¶ 424.) Instead, the 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." ID at 35. The Decision does not explain why a reasonable auditor or investor would deem

$2.9 million in net interest income remarkable, let alone material, in the context of TierOne's 2008 year-end $93 million pre-tax loss. This conclusion is contrary to the evidence, as neither Respondents' audit expert nor even the Division's expert supported it. (J.P.F. ¶ 424.) The Decision's failure to consider the whole record violates the APA and is reversible error. 5 U.S.C. § 556(d); *see Rockies Fund*, 428 F.3d at 1098.

B. The ALJ Makes Erroneous Evidentiary and Procedural Findings That Critically Undermine the Decision's Analysis

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

The ALJ erroneously admitted the report and testimony of the Division's proffered economic expert, Professor Anjan Thakor. In his report, Professor Thakor did not even purport to opine on the relevant measure required by the accounting standards: the fair value of each unique piece of collateral. Instead, his report candidly states: "I do not express an opinion here on what TierOne's ALLL on any FAS 114 loan should have been as of December 31, 2008. Rather, *I simply calculate how TierOne's calculated 'Required ALLL' would have changed had the publicly-available market data been used to discount appraisals*." (Div. Ex. 191, Thakor Report ¶ 346 (emphasis added).) And at the hearing, Professor Thakor purported to interpret FAS 157, testifying that fair value estimates should include forced sales contrary to its express language and the testimony of the Division's audit and accounting expert, Mr. Barron. (Tr. 191:19-203:5.) Perhaps Mr. Thakor's error should not be surprising, as he is neither a CPA nor an accounting expert. (J.P.F. ¶ 509.) In short, Professor Thakor was unqualified to give the opinions he proffered—opinions that do not comply with GAAP and bear no relevance on Mr. Aesoph's professional judgments in 2008.

Rule of Practice 320 provides that, the Commission "shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." Because "not all [expert] testimony is created

equal," *United States ex rel. Miller v. Bill Harbert Int'l Constr., Inc.*, 608 F.3d 871, 894 (D.C. Cir. 2010), Federal Rule of Evidence 702 requires expert testimony to be helpful, based on sufficient facts or data, and be the product of reliable principles and methods applied to the facts of the case. Fed. R. Evid. 702(a)-(d).

Professor Thakor's proffered opinions fail on all counts. He did not analyze fair value under FAS 157, yet he was permitted to offer testimony on fair value—testimony that appears to have been adopted by the ALJ despite it being contradicted by both audit experts. (*See* ID 33; J.P.F. ¶¶ 55-56, 61, 511-17.) When Professor Thakor mentioned the concept of fair value in his report (*see, e.g.*, Div. Ex. 191, Thakor Report ¶ 19), he completely ignored FAS 157, which is not cited once in its 241 pages. (J.P.F. ¶ 511.) Nor could Professor Thakor recall if he had any familiarity with the September 2008 OCA/FASB guidance; this, too, appears nowhere in his report. (J.P.F. ¶ 520.) Instead, he measured sales prices in disorderly markets using observed prices on distressed sales to extrapolate values into the future, making no effort to exclude forced transactions. (J.P.F. ¶¶ 514, 517.) Because Professor Thakor's invented calculation violates FAS 157, it is, or should have been, irrelevant to the Decision's judgments regarding the year-end 2008 audit.

ii. The Decision Makes Erroneous Findings Regarding the Auditors' Review and Evaluation of Regulatory Activity Affecting TierOne in 2008

The Decision directly contradicts the evidence with regard to the auditors' review and evaluation of the regulatory activities by the OTS, and these flawed findings contributed to its flawed legal conclusions. The record shows that Mr. Aesoph and his team devoted close attention to regulatory actions by the OTS 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 (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). Messrs. Aesoph and 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 audit 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.)

Despite this evidence, the Decision concludes that during his phone call with Messrs. Aesoph and Bennett, OTS Field Manager Douglas Pittman "gave no indication that . . . TierOne's [remedial] actions [in response to OTS regulatory activity] were effective." ID at 12-13. This ignores Mr. Pittman's testimony, which explained that (1) by the time he had spoken with the auditors in February 2009, he had received and reviewed a number of the Bank's required submissions; (2) management was receptive and was complying with OTS's demands; (3) he believed that management had the ability and was appropriately addressing identified issues; and (4) the Bank had the ability to comply with the supervisory agreement. (J.P.F. ¶¶ 204-10, 400.)

Given the evidence to the contrary, the Decision's conclusion regarding the auditors' evaluation of regulatory activity is clearly erroneous, and the result that it pays "no heed to [respondent's] evidence" on this issue is reversible error. *Rockies Fund*, 428 F.3d at 1098.

iii. The Decision Fails to Acknowledge the Prejudicial Impact of the Division's Failure to Develop a Complete Investigatory Record

The Decision focuses heavily on an alleged lack of support for the auditors' judgments. But the Decision refuses to consider and weigh the prejudicial effects of the Division's failure to

develop, preserve, and present a complete investigatory record consisting of the hundreds of loan files that support the auditors' observations and conclusions. The Division had the burden to prove its allegations by a preponderance of the evidence, but without a complete record, the Division could not carry this burden. *Steadman*, 450 U.S. at 102; *Pelosi*, Inv. Advisors Act Rel. No. 3805, 2014 SEC LEXIS 1114, at *8.

During the audit, Mr. Aesoph and his team examined the Bank's extensive loan files; these files were indeed vital audit evidence obtained in the quarterly reviews and year-end 2008 audit. 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 (credit histories, appraisals, interim and annual credit reviews) that provided evidence that the loss estimates were adequately supported. (J.P.F. ¶¶ 335-46.) Despite the importance of the loan files to this proceeding, the Division failed to develop and preserve a full investigatory record, obtaining files for only one-third of the loans on which its allegations rest. (J.P.F. ¶¶ 451-54.)

The ALJ finds that the Division's incomplete investigation is a matter of "prosecutorial discretion." ID at 3. But prosecutorial discretion extends only so far. The Division's failure to develop a complete investigation and record taints the evidence in a manner unreasonably prejudicial to Mr. Aesoph. For example, the Division's audit expert, Mr. Barron, admitted that the auditors undeniably consulted the loan files as referenced in the work papers but that he entirely ignored that substantial body of evidence. (J.P.F. ¶ 482.) He admitted that if he were an auditor seeking corroborative evidence on impaired loans, he would want to look at the loan files. (*Id.*) Mr. Barron also conceded that information in the loan files might have affected his expert opinions, had he reviewed them. (*Id.*) And most importantly, when confronted with information and documents from the loan files, Mr. Barron admitted opinions contained in his

report were wrong. (J.P.F. ¶ 484.) The Division's failure to use its investigative powers to obtain the loan files deprived Mr. Aesoph of a full and fair opportunity to defend himself, as, by the time Mr. Aesoph could obtain discovery, TierOne no longer existed.

Instead, the Decision concludes that Mr. Aesoph "had the full opportunity to point to information in the loan files to justify his conduct." ID at 3. This ruling is erroneous. The evidence presented at the hearing included the limited samples available from the Division, including several loan files the engagement team reviewed during the 2008 audit. (J.P.F. ¶ 338.) And even that limited collection was shown to support Mr. Aesoph's conclusions. (J.P.F. ¶ 343-46, 482.) Mr. Aesoph was not required to "justify" his conduct at trial; it was the Division's burden to prove a violation of Rule 102(e). And when the alleged violation is a lack of support for the auditors' decisions, the Division carries the burden of proving support was lacking from the *complete* record rather than from the limited and selected record it chose to create in the course of its investigation. Moreover, given the limited discovery and time afforded respondents in administrative proceedings—particularly compared to the nearly limitless discovery and time afforded the Staff during its investigation—the Staff's failure to develop a full record deprived Mr. Aesoph his ability to build a full defense.

iv. The Decision Makes Impermissible Assessments in Hindsight Based on Information Not Known to the Auditors During the Audit

The Decision notes that the Department of Treasury's Office of Inspector General issued a report in 2011 (the "OIG Report"), finding in part that TierOne failed primarily because of significant losses in its construction and land-development loan portfolio. ID at 5. The Decision relies upon the conclusions in the OIG Report to illustrate TierOne's failure to order updated appraisals when modifying loans or when material deterioration in property values was evident. *Id.* The Decision's reliance on this report 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. *See* 63 Fed. Reg. 57,164, 57,168.

The OIG Report was released a year after the OTS initiated a formal investigation of TierOne's board and management on suspicion of fraud and included findings resulting from that OTS investigation. This report was not and could not have been known to the auditors at the time of the audit. (*See* Div. Ex. 91.) The Decision's reliance on the OIG Report is further misplaced given that the OIG Report was not intended to review or comment upon the adequacy of Mr. Aesoph and his team's audit work, nor did it reach any conclusions about the audit or reflect upon applicable GAAP. It is prejudicial and reversible error to rely on this type of hindsight evidence.

C. Mr. Aesoph's Conduct Does Not Violate Rule 102(e)

The sanction against Mr. Aesoph is arbitrary and capricious. The heightened negligence standards under Rule 102(e)(1)(iv)(B) require proof that the auditor 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." 63 Fed. Reg. 57,164, 57,165. These heightened negligence provisions are "not intended to cover all forms of professional misconduct," but rather, the provisions encompass only egregious lapses in professionalism evidencing a threat to the Commission's mission of protecting the investing public. *Id.* at 57,165-66; *see McNeeley*, Exchange Act Rel. No. 68431, 105 SEC Docket 655, 2012 SEC LEXIS 3880, at *48-55 (Dec. 13, 2012).

The Commission and the courts have recognized limitations upon the scope of Rule 102(e)'s heightened negligence standards. First, the standards explicitly exclude "acts of simple negligence and errors in judgment." 63 Fed. Reg. 57,164, 57,167 (internal quotations omitted). Further, Rule 102(e) "does not permit judgment by hindsight, but rather compares the actions

taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation." *Id.* at 57,168. Finally, the Commission must avoid characterizing as negligent "difficult judgment calls made by a professional – which subsequently prove to be incorrect." *Potts*, Exchange Act Rel. No. 39126, 53 SEC Docket 187, 1997 SEC LEXIS 2005, at *57 (Sept. 24, 1997) (Comm'r Wallman, dissenting).

As the Commission has acknowledged, a professional often must make difficult decisions, navigate complex statutory and regulatory requirements, and comply with professional standards. These determinations require independent professional judgment and sometimes involve matters of first impression. *Checkosky*, Exchange Act Rel. No. 38183, 63 SEC Docket 1948, 1997 SEC LEXIS 137, at *50 (Jan. 21, 1997) (Comm'r Johnson, dissenting), *rev'd*, *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998). These types of difficult judgment calls—even if later shown to be wrong—are not within the scope of Rule 102(e)'s heightened negligence standards. 63 Fed. Reg. 57,164, 57,167-68; *Potts*, Exchange Act Rel. No. 39126, 53 SEC Docket 187, 1997 SEC LEXIS 2005, at *57.

The Division's evidence falls far short of the requisite level of proof, particularly given these standards and the gravity of a Rule 102(e) sanction. Almost concurrently with the 2008 year-end TierOne audit, the Commission's Staff specifically acknowledged that "[t]he current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information." (J.P.F. ¶ 58 (quoting the OCA/FASB September 2008 guidance).) So there is little doubt that in this case, with markets dominated by forced transactions, Mr. Aesoph faced particularly difficult challenges in forming his judgments regarding management's valuation of impaired loans. Those same judgment calls

by Mr. Aesoph surrounding TierOne's FAS 114 loan portfolio, when viewed in light of all the facts, do not justify the invocation of Rule 102(e) sanctions.

The Decision itself describes the work performed by Messrs. Aesoph and Bennett on other areas of the audit as in accordance with "the highest professional standards." ID at 31. The Decision finds fault only with Mr. Aesoph's review of TierOne's FAS 114 loans, but the Decision acknowledges 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 a significant number of hours to the 2008 audit and to TierOne's ALLL in particular, far in excess of hours spent in prior years, and demanded the same from his staff. (J.P.F. ¶¶ 180-82.) Mr. Aesoph also brought in multiple experts to assist specifically with loan audit work in light of the challenging market, including a credit specialist, and members of KPMG's financial services regulatory practice group. *Id.* at 7.

The Division's own audit expert conceded the many instances of professionalism and due care set forth in the record. (J.P.F. ¶¶ 471-75, 481-82, 489-91.) For example, Mr. Barron did not question Mr. Aesoph's technical competence, and he admitted that Mr. Aesoph understood the professional accounting standards and TierOne's process for estimating the ALLL. (J.P.F. ¶ 471.) He admitted that Mr. Aesoph properly recognized the risk of fraud and material misstatement presented by the FAS 114 portion of the ALLL, and he admitted that Mr. Aesoph appropriately identified the risk of collateral overvaluation. (J.P.F. ¶¶ 473-74.) He further admitted that Mr. Aesoph considered market information in evaluating the reasonableness of management's FAS 114 estimates. (J.P.F. ¶ 481.) And Mr. Barron conceded that Mr. Aesoph engaged in professional due care in a number of other ways, including by pressing management

to recognize a $42.1 million write-off of goodwill, involving a credit risk specialist on the engagement, involving KPMG's regulatory services group to review the OTS report, having Mr. Bennett analyze the OTS report, tracking TierOne's remediation of issues identified by OTS, discussing the OTS report with other KPMG partners, and contacting the OTS to discuss TierOne's performance under the Supervisory Agreement. (J.P.F. ¶¶ 489, 491.)

In addition, Mr. Aesoph's assessments on TierOne's FAS 114 portfolio were supported by ample evidence, particularly when viewed in light of GAAP's characterization of the estimate: viz., an estimate based by definition on "unobservable" inputs. In instances where management relied upon older, undiscounted appraisals, Mr. Aesoph and his engagement team sought out the rationale for management's collateral valuation as of the financial statement date by questioning management, reviewing the respective loan files, and consulting additional sources to reach a conclusion that management's valuations were reasonable under FAS 157. The Decision's determination (with the benefit of hindsight) that Mr. Aesoph's conclusions and judgment that sufficient evidence had been obtained were ultimately incorrect is not a permissible basis for finding a Rule 102(e) violation, and it is certainly not a permissible basis for imposing sanctions against Mr. Aesoph. *See Potts*, Exchange Act Rel. No. 39126, 53 SEC Docket 187, 1997 SEC LEXIS 2005, at *57.

The Decision further fails to consider the effect of management's fraud on the 2008 audit and Mr. Aesoph's substantial role in bringing that fraud to light. The fraud was directed precisely at the audit of impaired loan loss estimates. Management's intentional deceit is directly relevant to evaluating the persuasiveness of the audit evidence obtained, but the Decision fails to acknowledge the issue and refuses to recognize Mr. Aesoph's role in bringing the fraud to light. When Mr. Aesoph 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. (J.P.F. ¶ 449.) 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 internal control assessment. (J.P.F. ¶ 449-50.) The Commission filed complaints against management for, among other things, misleading Mr. Aesoph and his team, and a key audit contact, the Chief Lending Officer, recently pled guilty to parallel criminal charges. (J.P.F. ¶¶ 442-43; Plea Agreement in *United States v. Langford*, No. 4:14-cr-03103-JMG-CRZ (D. Neb. Sept. 9, 2014).) Notably, while the OTS had in-hand information that cast doubt on the reliability of management's representations, it took no immediate action. (J.P.F. ¶¶ 447-49.) Mr. Aesoph, on the other hand, caused KPMG to resign from the audit within days. (*Id.*) These actions are not the mark of an auditor that is a threat to the Commission's processes. Yet Mr. Aesoph's investigation and resulting decision to resign are given no mention, let alone appropriate consideration in the Decision.

The discipline imposed against Mr. Aesoph lacks foundation or justification, and it has gravely affected his public accounting career. Never before has the Commission ended the career of a public accountant under such facts and circumstances; where an auditor (1) proceeds under newly released Staff guidance on a difficult accounting principle amidst market upheaval; (2) recognizes the risks inherent in the audit, including those arising from unprecedented market conditions and regulatory oversight; (3) significantly increases procedures and time devoted to the audit in light of perceived risks; and (4) makes difficult judgment calls regarding subjective inputs on hard-to-value collateral, all the while being provided with fraudulent information from

management. Mr. Aesoph's conduct—both during and subsequent to the 2008 audit—demonstrates diligence and good faith and must be considered in determining whether sanctions are appropriate. 63 Fed. Reg. 57,164, 57,170.

D. The Decision Errs in its Application of Rule 102(e) Requirements

In addition to the lack of evidence supporting a violation or sanction under Rule 102(e), the Decision further fails to comply with the technical requirements of Rule 102(e). First, in assessing appropriate sanctions, the Decision errs 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 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. ID 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 Fin. Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989). Mr. Aesoph cannot be sanctioned for presenting the vigorous defense to which he is entitled.

In addition, the Decision adopts the "repeated instances of unreasonable conduct" theory under Rule 102(e) as an alternate ground to sanction Mr. Aesoph. ID at 36 n.38. This ruling erroneously conflates the distinct Rule 102(e) standards. The Commission, overruling another 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, 97 SEC Docket 1492, 2009 SEC LEXIS 4165, at *27 (Dec. 14, 2009). But 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. *See* 63 Fed. Reg. 57,164, 57,169. The Decision's attempt to use AU § 561 as the make-weight in this argument is wholly unavailing.

IV. CONCLUSION

When Mr. Aesoph signed the 2008 year-end audit report, he reasonably believed that the collateral fair values estimated by management were the product of a documented and supportable process. Mr. Aesoph's conclusions were based upon appropriate accounting guidance, including recently published Staff guidance on fair value. Mr. Aesoph applied this guidance in reviewing, understanding, and testing TierOne's valuation methodologies, documentation, and treatment of impaired loans over the course of the year. Mr. Aesoph requests that the Commission vacate the Decision and dismiss the charges against him.

Rule 450(d) Certification: Undersigned counsel certifies that this brief contains 14,000 words and therefore complies with the limitations set forth in Rule of Practice 450(c).

Dated: October 24, 2014

Respectfully submitted,

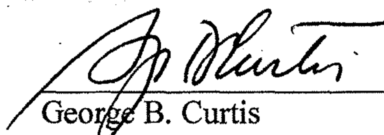

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EXHIBIT A

To Opening Brief of Respondent John J. Aesoph

Appraisals/Collat
Reviewed

Loans Reviewed (Risk Rating/Accrual Status)

Impaired Loans Identified and Portfolio Segregated

Group According to
Loan Type

Special Assets Executive
Prepares FAS 114 Templat
Estimating Loan Valuatior

Finance Department (Control
Reviews FAS 114 Templates

Asset Classification Committee
Reviews and Approves FAS 5 and
FAS 114 Allowance for Loan Loss

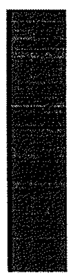
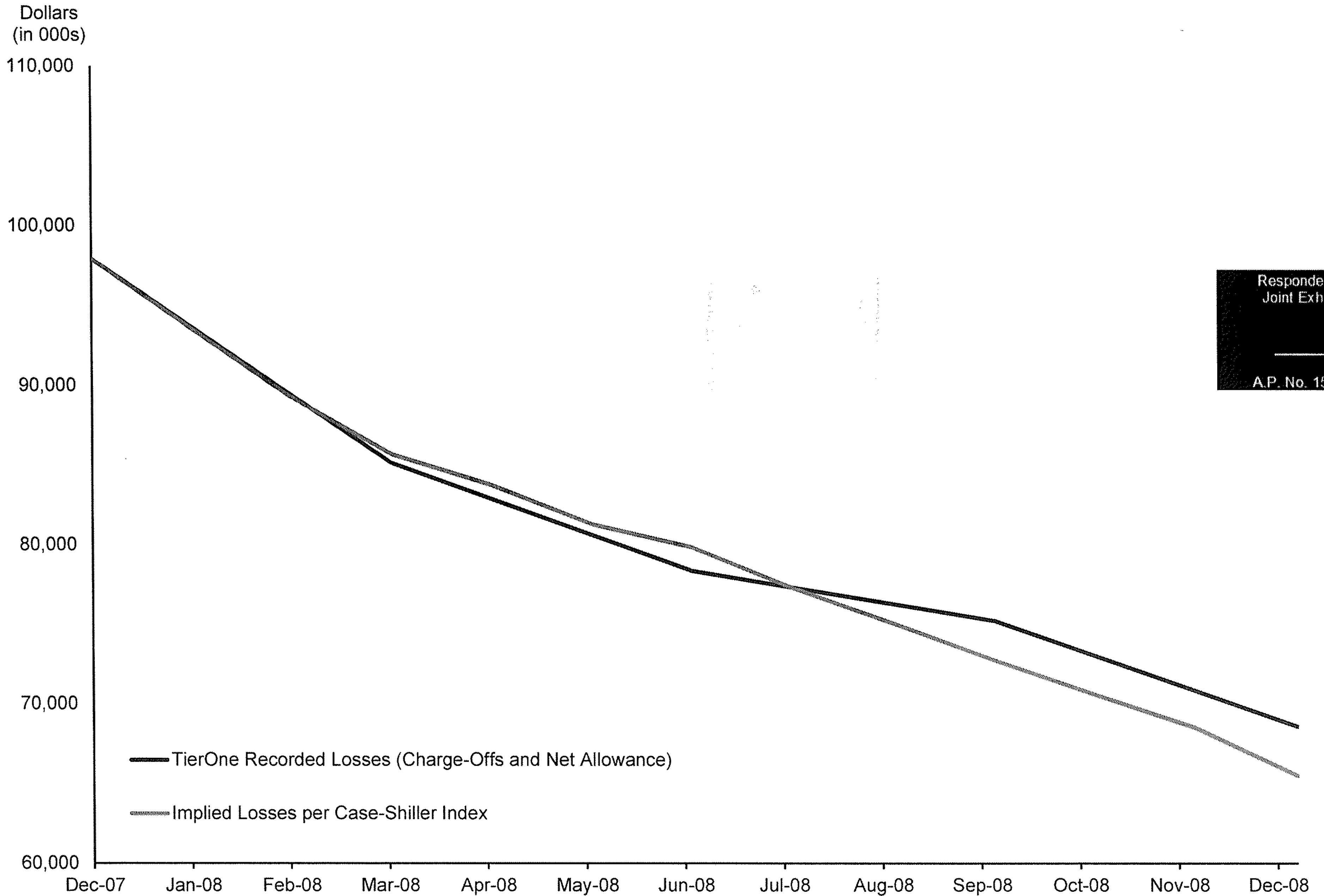


EXHIBIT B

To Opening Brief of Respondent John J. Aesoph

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



Respondents' Joint Exhibit

A.P. No. 15168