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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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ADMINISTRATIVE PROCEEDING
File No. 3-15168

In the Matter of

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

DIVISION OF ENFORCEMENT'S OPPOSITION TO OPENING BRIEFS OF RESPONDENTS JOHN J. AESOPH AND DARREN M. BENNETT

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. FACTUAL BACKGROUND 4

A. TierOne's Troubled Loan Portfolio 4

B. Respondents' Acknowledgment of the Significant Risks Related to TierOne's FAS 114 Loans 8

C. Respondents' Unqualified Audit Opinion and TierOne's Ultimate Failure 10

D. The ALJ's Fulsome Hearing and Thorough Decision 11

III. DISCUSSION 12

A. The ALJ Did Not Ignore Evidence 12

1. The ALJ Did Not Consider Only the Division's Evidence 12

2. The ALJ Did Not Exclude Evidence Under AS No. 3 13

3. The ALJ Did Not Ignore Respondents' Expert Witnesses 15

B. The ALJ Correctly Found that Respondents Violated Basic Audit Standards 17

1. Respondents Performed a Cursory Audit over a Critical Account 17

a. PCAOB Standards: Respondents Were Required to Act with Due Care, Gather Competent Evidence, and Consider Market Conditions 17

b. Respondents' Audit Fell Short of Professional Standards 19

2. Respondents' *Post-Hoc* FAS 157 Argument Does Not Save Their Deficient Audit 22

a. The ALJ Correctly Found FAS 157 Was Not a Part of Respondents' Audit Procedures 23

b. The ALJ Correctly Interpreted FAS 157 27

3. Respondents' Other Undocumented Procedures Do Not Save Their Deficient Audit....28

a. Respondents' Purported Review of Loan Files Did Not Provide Competent Evidence that TierOne's Collateral Valuations Were Reasonable....28

b. Respondents' Purported Confirmation of Losses in 2008 Did Not Provide Competent Evidence that TierOne's Collateral Values Were Reasonable....30

4. Many of Respondents' Additional Arguments are Precluded By Their Admissions....33

5. Respondents Improperly Rely on Numerous Procedures Unrelated to the FAS 114 Loans....35

C. The ALJ Correctly Found that Respondents' Audit of Internal Controls Violated Professional Standards....36

1. PCAOB Standards: Auditors are to Identify and Test Controls in Areas of Highest Risk....36

2. The Control Respondents Identified to Address the Risk of Collateral Overvaluation Did Not Sufficiently Address the Risk....36

D. The ALJ Correctly Found That Respondents Violated PCAOB Standards by Engaging in No Review Under AU 561....39

1. PCAOB Standards: Auditors Must Follow Up on Facts Which Might Have Affected Their Audit Opinion....39

2. Respondents Failed to Perform *Any* AU 561 Review....39

E. The ALJ Correctly Found that Respondents Violated Rule 102(e)....41

IV. CONCLUSION....45

TABLE OF AUTHORITIES

Cases

Black v. Apfel, 143 F.3d 383 (8th Cir. 1998) 13

Carlson v. Shalala, 999 F.2d 180 (7th Cir. 1993) 13

Gregory M. Dearlove, CPA, Rel. No. 34-57244, 2008 WL 281105 (Jan. 31, 2008) 16, 17, 18, 43

Haskins & Sells, Accounting Series Rel. No. 73 (Oct. 30, 1952) 16

James Thomas McCurdy, 2002 WL 1841565, (Aug. 13, 2002) 18

James Thomas McCurdy, Rel. No. 34-49182, 2004 WL 210606 (Feb. 4, 2004) 42

Kevin Hall, CPA and Rosemary Meyer, CPA, Rel No. 34-61162, 2009 WL 4809215 (Dec. 14, 2009) 14, 17, 43

Morall v. DEA, 412 F.3d 165 (D.C. Cir. 2005) 12

S.W. Hatfield, CPA, Rel. No. 34-69930, 2013 WL 3339647 (2013) 26

Touche Ross & Co., Rel. No. 33-5459, 1974 WL 161425 (February 25, 1974) 45

Wendy McNeeley, CPA, Rel. No. 34-68431, 2012 WL 6457291 (Dec. 13, 2012) 15, 16, 26, 44, 45

Statutes

17 C.F.R. § 201.102(e)(1)(iv) 11, 33, 41, 42, 44, 45

Other Authorities

Amendment to Rule 102(e), 63 Fed. Reg. at 57, 167 41
AS No. 3 .... 3, 13, 14, 15, 29, 30, 31
AS No. 5 .... 36, 38
AU 150 17
AU 230 17
AU 326 18
AU 328 18
AU 333 18
AU 342 17
AU 561 .... 39, 40, 41

TABLE OF RECORD CITATION ABBREVIATIONS

"ID-__"	Initial Decision, at page __.
"Tr.-__"	Hearing Transcript, at page __.
"DX-__, __"	Division's Exhibit __, at page __.
"RX-__, __"	Respondents' Exhibit __, at page __.
"DF __"	Division's Proposed Findings of Fact, fact number __ (filed Dec. 10, 2013).
"JPF-__"	Respondents' Joint Proposed Findings of Fact, fact number (filed Dec. 10, 2013).
"AB-__"	Opening Brief of Respondent John J. Aesoph, at page __ (filed Oct. 24, 2014).
"BB-__"	Brief of Respondent Darren M. Bennett, at page __ (filed Oct. 24, 2014).

I. INTRODUCTION

The core question in this case is whether Respondents' audit work over an account they have conceded was one of the highest-risk areas of their audit violated professional standards. In a thorough Initial Decision, the Administrative Law Judge correctly found that it did. Respondents attack that Decision on all fronts, tacitly conceding that they cannot escape liability unless the Commission finds that the ALJ erred across the board. In doing so, Respondents attempt to re-write what occurred during the audit, hanging their arguments on procedures they claim they performed, but that are not documented in the audit workpapers or supported by evidence contemporaneous to the audit. Respondents also attempt to re-write the Decision itself, repeatedly arguing the ALJ excluded or ignored certain evidence that she plainly did not. Respondents' arguments cannot overcome the evidence of their insufficient audit.

The ALJ correctly found that Respondents engaged in highly unreasonable conduct in their year-end 2008 audit over the Allowance for Loan and Lease Losses ("ALLL") account of TierOne Corporation ("TierOne"), and specifically in their work over the component of the ALLL that involved losses on large, non-homogenous loans evaluated under Statement of Financial Accounting Standards No. 114 ("FAS 114"). TierOne calculated the losses on its FAS 114 loans by comparing the value of the loan with the value of the collateral securing the loan. At the time of Respondents' audit, there were significant red flags highlighting the risks related to the FAS 114 portion of the ALLL. For example, in calculating collateral values, TierOne often relied on appraisals that were nearly a year old despite the historic losses in real estate markets in 2008, especially in Nevada and other states where TierOne's FAS 114 loans were concentrated. In addition, TierOne's primary regulator, the Office of Thrift Supervision ("OTS"), had issued a report criticizing TierOne's lending practices for the very loans that made up the majority of the

FAS 114 portfolio. Moreover, Respondents conceded that the FAS 114 portion of the ALLL was a high-risk audit area that was individually material to TierOne's financial statements.

Even so, as the ALJ correctly found, Respondents' audit procedures over this critical area were severely lacking. For example, although TierOne frequently used stale appraisals to value the underlying collateral – a practice that was particularly suspect given the massive real estate market declines in 2008 – Respondents regularly relied on those obviously flawed appraisals in their audit work. Respondents simply presumed that any appraisal less than a year old was "current," and did nothing more than "inquire" of management if an appraisal was any older. Similarly, Respondents failed to identify or test a control that related to a key risk point – that collateral would be overvalued. And finally, even though Respondents later discovered appraisals that existed prior to their audit opinion and that reflected significant declines in values, they performed no assessment of whether the appraisals might have affected the year-end financial statements even though professional standards require inquiry in such circumstances. Basing her decision almost entirely on Respondents' own evidence – their audit workpapers and admissions at trial – the ALJ correctly found that Respondents' cursory procedures did not demonstrate the due care and professional skepticism required of an auditor.

As they did at the hearing, rather than attempt to explain how the procedures documented in the audit workpapers met professional standards, Respondents rest their defense on numerous procedures that they claim they performed, but are concededly not documented. Most notably, Respondents insist the ALJ's fundamental error was in her interpretation of FAS 157's fair value standard that, Respondents contend, significantly informed their audit procedures. But the overwhelming evidence shows that, during the audit, Respondents did not assess the FAS 114 loans using the interpretation of FAS 157 they now proffer. There is no reference to FAS 157 in

the ALLL workpapers, and KPMG's separate workpaper on FAS 157 – which, even at the hearing, Bennett did not know existed – makes no mention of FAS 114 or the ALLL. Moreover, neither Respondent mentioned FAS 157 in their multiple days of investigative testimony. Nor do their Wells submissions advance their current FAS 157 argument. Respondents' newfound reliance on FAS 157 is a litigation-made argument that does not reflect the audit actually performed: as the ALJ correctly found, "[t]he record belies Respondents' assertion that, in evaluating TierOne's FAS 114 estimates, they conducted any sort of review consistent with their proffered interpretation of FAS 157." [ID-33.] Respondents' continued attempts to explain away their deficient audit work by reference to this and other undocumented procedures demonstrate the deficiency of the audit actually performed, and should be rejected.

In addition to resting on undocumented work to attempt to justify their conduct, Respondents also attempt to reinterpret the Decision itself. Most notably, they repeatedly insist that the ALJ excluded or disregarded their evidence. That is simply not the case. For example, while the ALJ properly explained the PCAOB standard on audit documentation – that auditors "must document the procedures performed, evidence obtained, and conclusions reached," AS No. 3 ¶6 – she did not exclude evidence of Respondents' undocumented procedures. Rather, she correctly explained why those procedures, even if they had occurred, did not save the deficient audit. Similarly, Respondents insist the ALJ ignored their expert witnesses, going so far as to claim the testimony of their accounting expert "is never discussed – ***not once***." [AB-24 (emphasis added).] In fact, Respondents' experts are specifically mentioned in the Decision, along with a summary of their essential opinions. Moreover, the ALJ heard hours of testimony from the experts, and accepted their written reports. That the Decision did not spend even more

time discussing the experts is not fatal; as the Commission has previously explained, it does not need expert testimony to determine whether auditing standards were met.

In the final analysis, the ALJ correctly found Respondents' audit fell far short of professional standards in a high-risk, individually material audit area. Respondents' *post hoc* arguments, based primarily on undocumented procedures, should be rejected. The ALJ's liability determinations should be affirmed.

II. FACTUAL BACKGROUND

A. TierOne's Troubled Loan Portfolio.

Aesoph and Bennett were the partner and senior manager on the audit of TierOne's 2008 financial statements. [DF 48, 273.] Although TierOne was a regional bank that historically focused on its primary market area of Nebraska, Iowa, and Kansas, in the mid-2000's TierOne expanded and opened numerous loan production offices ("LPOs") to make large loans in places like Nevada, Arizona, and Florida. [ID-4.] Those states were hard hit by the Great Recession, and in mid-2008 TierOne closed its LPOs as part of its "effort to reduce [its] exposure to higher risk loans." [DX-130, 7; see also ID-4, 14.] Even so, at year-end 2008 a significant portion of TierOne's loan portfolio remained concentrated in the LPO states. [DX-130, 12; DF 107, 282.]

TierOne recorded losses on loans through its ALLL, a balance-sheet account intended to cover known and inherent losses in the bank's loan portfolio. [ID-7.] The ALLL consisted of two main components: losses on impaired loans evaluated under FAS 114; and losses on non-impaired loans evaluated under FAS 5. [ID-7.]

TierOne estimated its ALLL on FAS 114 loans on a loan-by-loan basis, preparing individual "templates" for FAS 114 loans over a threshold amount. [DF 64; ID-8.] Because TierOne's FAS 114 loans were collateral dependent – meaning the bank expected repayment

from the sale of the real estate underlying the loan – TierOne calculated the ALLL by comparing the estimated book value of the loan to the fair value of the collateral (with some adjustment for cost and time to sell). [DF 65, 71.] The ALLL was the difference between the present value of the collateral and the estimated book value. [DF 67.] Put simply, collateral values drove losses on FAS 114 loans. [DF 72.]

By the time of Respondents' audit, there were serious warning signs that collateral values on FAS 114 loans were overstated and, thus, that losses may be understated. TierOne generally used appraisals of the underlying real estate to calculate collateral values. [DF 73.] At year-end 2008 those appraisals were often stale – from the first half of 2008 or earlier. [ID-17; DF 32, 37; see generally DX-120, KPMGTO0005484-5548.] TierOne used these stale appraisals despite the fact that the vast majority of the FAS 114 loans – more than 80% – were secured by collateral in LPO states that had seen record market declines throughout 2008. [DX-120, KPMGTO0005436; DF 132-137, 295; Tr.-476:22-477:3.] For example, Nevada, the location of approximately half of all TierOne's FAS 114 loans, saw markets drop more than 30% in 2008. [DF 18, 19, 133, 426.] Even so, not one Nevada FAS 114 loan was assessed using an appraisal more recent than July 2008, and many had appraisals from the first few months of the year. [DF 32.] Critically, these appraisals generally were not discounted to reflect the significant market declines between the appraisal date and year-end.[1] [DF 26.]

Further underscoring the risks in TierOne's ALLL account, shortly before Respondents' 2008 audit the OTS issued a damning examination report that directly criticized the bank's loan practices, particularly in LPO markets. [ID-9-10; DX-81.] Specifically, the report found:

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[1] Aesoph argues that there were "[i]n effect" no undiscounted appraisals, because loans were discounted for the time it would take to sell the collateral. [AB-8.] However, as Respondents' accounting expert conceded, this present value discount had nothing to do with adjusting for the age or staleness of the appraisal. [DF 493; see also DF 408.]

- "Credit underwriting [was] deficient and credit administration practices [were] inept";
- Many of these deficient practices related to "out-of-territory construction and land development lending, particularly in the Las Vegas portfolio," and included "loans with no appraisal[s], unsupported appraisals, and stale appraisals";
- Management's performance was "exceptionally poor" and had resulted in violations of fiduciary duties;
- "The level of problems and risk exposure [was] extreme";
- TierOne had effectively surrendered oversight and control of the LasVegas LPO – which produced a significant volume of FAS 114 impaired loans – to a regional manager, which resulted in an office "defined by reckless, high risk lending activities and a blatant disregard for prudent credit administration procedures";
- TierOne "experienced a marked deterioration in asset quality due to eroding residential real estate values in southwest Florida and Nevada exacerbated by poor board and management oversight"; and
- "The bank's deteriorating financial condition [was] principally the result of poorly administered concentrations of higher risk credits in rapidly flagging national markets that, until recently, were hotbeds for lending activity," noting that management and the board had not satisfactorily monitored or responded to declining market conditions or the impact of those conditions on TierOne's assets and the adequacy of its ALLL.

[ID-4, 9; DX-81, KPMGTO0001377, 1386, 1391-92 1398; see also DF 508-515.] In short, the OTS report shone a harsh light on TierOne's lending practices on the very loans that made up the vast majority of the FAS 114 loan portfolio, underscoring the critical risks in that audit area.

As a result of its examination, the OTS downgraded TierOne from its highest rating to its second-lowest. [ID-10; DF 434.] This downgrade moved TierOne from a bank that was "sound in every respect" to one that "generally exhibit[ed] unsafe and unsound practices or conditions." It also meant that TierOne had

> serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

[DF 516.] Douglas Pittman, the field manager for the OTS examination, had never before seen a bank so drastically downgraded in one examination cycle. [DF 434.]

The OTS also increased TierOne's regulatory capital ratio requirements, breach of which could have led to significant enforcement action. [ID-10; DF 117, 121.] These capital ratios were directly impacted by additional loan losses: more losses would drive the ratios down, closer to breach. [ID-10; DF 120.] At year-end 2008, TierOne stood just tenths of a percent above the required ratios. [ID-10; DF 123.][2]

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[2] Respondents attempt to downplay the significance of the OTS report by noting they consulted KPMG's regulatory group and spoke with Pittman as part of the audit. [AB-35-36; BB-12, 31-32.] But neither of these actions could have given Respondents comfort that the report was not a serious red flag. The regulatory group's response only underscored the seriousness of OTS's findings, reporting, for example, that "[g]iven the unsatisfactory condition of TierOne, ... 'Regulatory Risk' is considered high." [DF 126.] And while Pittman did say TierOne had been submitting information in a timely manner, he emphasized that it would not be until a future exam that the OTS would or could evaluate whether TierOne's new policies were mitigating the issues noted in the report. [DF 131, 443-445.] Aesoph contends the Decision's finding that Pittman gave Respondents no assurances that TierOne's actions were "effective" "ignores Mr. Pittman's testimony." [AB-36.] To the contrary, Pittman clearly testified that he told

B. Respondents' Acknowledgment of the Significant Risks Related to TierOne's FAS 114 Loans.

Respondents were acutely aware of these risks. For example, Respondents were aware of the record deterioration in real estate markets throughout 2008, specifically in places like Nevada, Arizona, and Florida, and Aesoph was aware that market conditions in the second half of 2008 were worse than the first half of the year. [ID-14; DF 97, 132-137, 279, 295.] Indeed, Bennett acknowledged that the deterioration in the real estate markets was driving impairments and loan loss reserves. [DF 135.]

Respondents were also aware of the risks related to stale appraisals. Aesoph confirmed that the age of an appraisal can impact the determination of fair value, particularly where there were significant changes to the collateral or the market where the collateral is located. [DF 299-301.] Bennett recognized that stale appraisals required significant scrutiny in assessing fair value. [DF 79; see generally DF 76-78.] And Aesoph conceded that "using stale appraisals ... to value collateral for the FAS 114 loans was a risk associated with the ALLL" at the time of the audit. [Tr.-805:16-23.]

Similarly, Respondents reviewed the OTS report, were aware of its critical findings, and conceded its serious nature. [ID-12; DF 100-101, 281-282.] Respondents were also aware of the OTS's increased capital ratio requirements. [DF 284.] Indeed, despite Aesoph's claim on appeal that there was "no indication management sought to avoid recording losses" at year-end 2008 [AB-8] at the hearing he expressly acknowledged that the increased capital ratios could lead to

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Respondents that OTS's assessment of the effectiveness of TierOne's actions would not come until a subsequent examination. [Tr.-1428:1-7 ("TierOne Bank was submitting ... documents in a timely manner, and [OTS] would review them to determine whether they were appropriate, and [OTS] would subsequently review any actions that they had taken with regard to policies and procedures or other activities during the subsequent examination to determine whether they were, in fact, effective.").]

pressure on management to understate losses, meaning management could be reluctant to book loan loss reserves when necessary in order to maintain the bank's capital. [ID-12; Tr.-756:15-757:12.] Indeed, Aesoph agreed that the increased ratios gave management a specific incentive not to recognize losses associated with FAS 114 loans. [ID-12; Tr.-844:7-12.]

In planning their audit, Respondents acknowledged the significant risks surrounding the ALLL. [See ID-11-12.] Respondents identified the ALLL being improperly calculated or monitored, or inadequate, as the only unique risk at the financial statement level that could result in a material misstatement or material weakness. [DF 84, 288.][3] Further, the ALLL was the only balance sheet account with a high "inherent risk" of error and a risk of fraud, i.e., a risk that TierOne might intentionally understate the ALLL. [DF 85-86, 289-292.] KPMG further noted in its audit planning that, given "increased pressure to improve financial performance," it needed to "audit estimates such as ALLL with an increased sense of professional skepticism and ensure that all estimates are reasonable and properly/adequately supported." [DX-118, KPMGTO0003699; Tr.-412-14.] These risks only heightened Respondents' professional duties: they acknowledged they were required to obtain more reliable evidence, be particularly skeptical of managements' estimates, and give the area significant emphasis. [DF 87, 289, 292.]

Respondents further identified audit risks related to the FAS 114 loans specifically, and noted those risks centered on TierOne's valuation of collateral. [See ID-11-12.] Bennett noted that FAS 114 portion of the ALLL was a significant estimate because of the risks related to collateral valuation. [DF 89; see also DF 293.] Similarly, Aesoph acknowledged that use of stale appraisals to value collateral for the FAS 114 loans was a risk associated with the ALLL at year-end 2008. [DF 302, 304.] Respondents further recognized that the ALLL was significantly

[3] The other two risks identified were required to be recognized on every audit. [DF 378.]

affected by TierOne's judgment in "[v]aluing the underlying collateral securing the loan," which specifically related to the "use of appraisals." [DX-117, KPMGTO0002417.]

In sum, as Bennett confirmed, the FAS 114 impaired loans were a significant focus point for the audit. [DF 81.] Further, as Respondents and their accounting expert conceded, the FAS 114 portion of the ALLL was individually material to TierOne's financial statements. [DF 138, 294, 381, 482.] As a result, Aesoph acknowledged that Respondents needed to perform sufficient audit procedures over, and obtain persuasive evidence supporting, the FAS 114 portion of the ALLL, and if Respondents failed to do either of those things "***then KPMG would not have a reasonable basis to render its audit opinion***." [Tr.-1800:20-1801:11; see also ID-12.]

C. Respondents' Unqualified Audit Opinion and TierOne's Ultimate Failure.

Despite acknowledging the risks, and as discussed in detail below, Respondents' audit over the FAS 114 portion of the ALLL was lacking. Respondents passed on any real scrutiny of TierOne's collateral valuation decisions, deeming any appraisal a year old or less "current" despite precipitous market declines and failing to gather competent evidence to justify TierOne's repeated use of stale appraisals. See Section III.B. Respondents also failed to identify or test a control that related to a key risk point that they themselves identified – that collateral would be overvalued at the time of the year-end 2008 financial statements. See Section III.C. And finally, when Respondents discovered (after the audit) appraisals that existed prior to their audit opinion, that reflected material declines in collateral value, and that TierOne had not used in its year-end 2008 valuation calculations, Respondents took no action to assess whether any of the losses those appraisals revealed should have been recorded as of year-end 2008. See Section III.D.

In spite of these insufficient procedures, in March 2009 KPMG issued an unqualified audit opinion. [ID-5.] Respondents personally attested that all necessary audit procedures were

completed, sufficient appropriate audit evidence was obtained, and appropriate documentation was prepared and reviewed. [ID-11.]

Just a few months after the audit, TierOne obtained updated appraisals and disclosed a staggering $120 million in losses related to its loan portfolio. [ID-5; DF 349.] In June 2010, the OTS closed TierOne. [ID-5.] KPMG also withdrew its audit opinion, finding that TierOne's 2008 financial statements contained material misstatements related to the bank's loan loss reserves, and that TierOne had a material weakness in its internal controls. [ID-5.][4]

D. The ALJ's Fulsome Hearing and Thorough Decision.

On January 9, 2013, the Commission filed an Order instituting these proceedings. The hearing was initially set to commence on July 15, 2013. However, as a result of a medical condition developed by Respondent Bennett's counsel, the ALJ agreed to postpone the hearing by several additional months. Beginning in October 2013, the ALJ held nine days of hearings at which Respondents testified extensively, presented and cross-examined witnesses, and introduced myriad exhibits. After receiving a six-month extension of time to file an initial decision, on June 27, 2014 the ALJ issued a thorough Decision assessing the Division's allegations and Respondents' defenses, analyzing the evidence and arguments, and ultimately finding Respondents violated Rule 102(e) by engaging in improper professional conduct in the 2008 audit. That liability determination should be affirmed.[5]

[4] Respondents suggest the ALJ improperly relied on evidence of what occurred after Respondents' audit. [AB-38; BB-15.] In fact, while the Decision mentions TierOne's ultimate failure, it properly bases its liability conclusions on Respondents' conduct during the audit.

[5] As explained in the Division's opening brief, given the ALJ's well-supported liability findings, more significant sanctions should be imposed.

III. DISCUSSION

Respondents attack every aspect of the Decision, essentially acknowledging that in order to prevail, the Commission must find the ALJ erred in whole. As explained in detail below, Respondents' arguments fail, as the ALJ correctly found their conduct was an extraordinary departure from basic professional standards. Before turning to those issues, the Division first responds to Respondents' claims that the ALJ improperly treated their evidence.

A. The ALJ Did Not Ignore Evidence.

Respondents argue that the ALJ took a one-sided view of the evidence, overlooked their expert witnesses, and excluded evidence under the PCAOB's audit documentation standards. In fact, the ALJ did not exclude any of Respondents' evidence, but rather admitted their exhibits, heard their testimony and that of their experts, and issued a substantial, well-reasoned Decision that explained the basis for her ruling. Respondents' arguments that the Decision did not fairly consider the evidence on both sides should be dismissed.

1. The ALJ Did Not Consider Only the Division's Evidence.

Respondents accuse the ALJ of failing to consider the evidence on both sides, and of issuing a Decision that did not appropriately discuss the basis for her findings. As a threshold matter, Respondents' contention that the ALJ ignored their evidence rings hollow, since the Decision is grounded almost entirely in Respondents' workpapers and testimonial admissions – evidence Respondents themselves generated in the audit, the investigation, and the hearing. Cf. Morall v. DEA, 412 F.3d 165, 178-79 (D.C. Cir. 2005) (finding fault with agency decision that gave no indication it considered petitioner's own testimony, which was credited by the ALJ, instead relying wholly on investigator's testimony).

Moreover, the ALJ did not run afoul of constitutional principles or the mandates of the Administrative Procedures Act ("APA") by not issuing an even more detailed decision explaining the basis for her acceptance or rejection of each fact or issue. An ALJ "need not evaluate in writing every piece of testimony and evidence submitted." Carlson v. Shalala, 999 F.2d 180, 181 (7th Cir. 1993); see also Black v. Apfel, 143 F.3d 383, 386 (8th Cir. 1998) ("An ALJ's failure to cite specific evidence does not indicate that such evidence was not considered."). Indeed, this case demonstrates precisely why such discretion is important: the hearing generated over 2,300 transcript pages and more than 150 exhibits (including hundreds of pages of expert reports), and Respondents proffered more than 500 proposed findings of fact spanning in excess of 150 pages. If ALJs did not have discretion to summarize their analysis, initial decisions would quickly become unwieldy. The Decision assesses the key evidence and arguments on both sides, makes specific findings of fact, and explains the basis for its legal conclusions. The Decision passes constitutional and statutory muster.

2. The ALJ Did Not Exclude Evidence Under AS No. 3.

Respondents also insist that it was improper for the ALJ to use the PCAOB's standard on audit documentation – AS No. 3 – as an "exclusionary rule" to disregard evidence. [AB-20-24; see also BB-17-18.] They focus on the ALJ's assessment of several purportedly key audit procedures that are not documented in the audit workpapers. The Division addresses the substance of these undocumented procedures below. However, as a preliminary matter, the Commission should reject Respondents' claim that the Decision misapplied AS No. 3. Respondents' not only misstate the standard, they mischaracterize how the ALJ treated the evidence of the undocumented procedures, which she pointedly did ***not*** exclude.

As the PCAOB explained in adopting AS No. 3, audit documentation is one of the "fundamental building blocks" on which the integrity of audits and the oversight of auditors rests. AS No. 3 Appx ¶A4.

> Meaningful [regulatory] reviews … would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential to enhance the quality of the audit and, at the same time, to allow the [regulator] to fulfill its mandate to inspect registered public accounting firms to assess the degree of compliance of those firms with applicable standards and laws.

Id.

Thus, PCAOB standards make clear that an auditor "must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." AS No. 3 ¶6; see also Kevin Hall, CPA and Rosemary Meyer, CPA, Rel No. 34-61162, 2009 WL 4809215, *9 (Dec. 14, 2009). The PCAOB deliberately chose the term "must" "to establish a higher threshold for the auditor" – "[a]uditors have an unconditional requirement to document their work." Id., Appx. ¶A26. Further, "[a]udit documentation must clearly demonstrate that the work was in fact performed." Id. ¶6. While an auditor must use judgment in determining precisely what and how to document, "accounting estimates," like the ALLL at issue here, "require greater judgment and commensurately more extensive documentation." Id. ¶7.

Aesoph argues that the PCAOB has rejected any "presumption" that lack of documentation is equated with lack of work. [AB-23.] This argument takes the PCAOB's reasoning out of context. While the PCAOB removed the phrase "rebuttable presumption" from the standard, it "continue[d] to stress … that the auditor must have persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached." AS No. 3, Appx ¶A25. The PCAOB further emphasized that "oral explanation alone"

– which is all Respondents offer here – "does not constitute persuasive other evidence." Id. ¶A28.

Further, regardless of whether a formal "presumption" is needed, both the PCAOB and the Commission have emphasized that "if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done." Id. ¶A10; see also Wendy McNeeley, CPA, Rel. No. 34-68431, 2012 WL 6457291, *13 (Dec. 13, 2012) (the Commission has consistently considered "the absence of workpapers to be evidence that the audit team did not devote substantial, if any, effort to review the areas in question"). In short, given the lack of any audit documentation or contemporaneous written evidence of Respondents' purported procedures, it would be appropriate to disregard Respondents' claims that the undocumented procedures occurred.

But in fact, the ALJ did not "exclude" any evidence under AS No. 3. To the contrary, the ALJ permitted Respondents to testify at length about the purported procedures at the hearing. Further, for each of the undocumented procedures, the Decision explains why, even if such procedures occurred, they were not sufficient to save Respondents' deficient audit. [See ID-32-34, 19-20.] As explained in detail below, the ALJ's analysis was correct. But for present purposes, Respondents are simply wrong when they suggest evidence was excluded under AS No. 3.

3. The ALJ Did Not Ignore Respondents' Expert Witnesses.

Respondents also claim the Decision is flawed because it did not properly consider their expert witnesses. This argument misapprehends both the facts and the law.

Factually, Respondents are wrong when they insist that the ALJ failed to consider the testimony of their experts. The ALJ accepted the experts' voluminous written reports into

evidence, and also permitted several hours of direct expert testimony at the hearing. Nor is the Decision silent on those expert witnesses. Aesoph claims that Respondents' accounting expert, Sandra Johnigan, "is never discussed – ***not once***." [AB-24.] In fact, the Decision addresses that expert, and all experts, summarizing their qualifications and testimony. [ID-21.] Thus, Aesoph's claim that "[f]rom the Decision, one would never know that Ms. Johnigan discussed the relevance of FAS 157 to the audit" is belied by the Decision, which specifically notes that Johnigan opined on "the definition of fair value in FAS 157." [Compare AB-24 with ID-21.] Similarly, Aesoph's insistence that "[o]ne 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 with a reasonable basis for issuing an unqualified audit opinion" is directly contradicted by the Decision's explicit reference to Johnigan's opinion that "Respondents complied with PCAOB auditing standards and that the engagement team obtained sufficient competent evidential matter to afford a reasonable basis for the audit opinion." [Compare AB-25 with ID-21.] Respondents' claims that their experts were not considered should not be credited.

Further, it is not the law, as Respondents suggest, that there must be expert testimony to assess violations of PCAOB standards or interpret GAAP. Quite the contrary, "the Commission has its own expertise and is not bound by expert testimony regarding auditing standards." McNeeley, 2012 WL 6457291, at *18; see also id. ("'[W]hile the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice.'") (quoting Haskins & Sells, Accounting Series Rel. No. 73 (Oct. 30, 1952); Gregory M. Dearlove, CPA, Rel. No. 34-57244, 2008 WL 281105, *20 (Jan. 31, 2008) ("The Commission may consider expert testimony,

but it is not bound by such testimony even where it is available, and the absence of expert testimony does not preclude the Commission from making necessary findings with respect to principles of accounting."). The fact that the Decision does not contain a lengthy dissertation on any party's expert witness is not a basis for reversal. And as explained below, the ALJ's assessment of Respondents' violations of PCAOB standards was correct, grounded in clear evidence, and should be affirmed.

B. The ALJ Correctly Found that Respondents Violated Basic Audit Standards.

1. Respondents Performed a Cursory Audit over a Critical Account.

Respondents acknowledged that the FAS 114 portion of the ALLL had significant audit risks and was individually material to TierOne's financial statements. Given this convergence of risk and materiality, Respondents were required to perform more extensive testing, gather more reliable evidence, and exercise a heightened sense of professional skepticism. [DF 54, 377, 483.] Respondents' audit work fell far short.

a. PCAOB Standards: Respondents Were Required to Act with Due Care, Gather Competent Evidence, and Consider Market Conditions.

Basic auditing standards require due professional care in the performance of an audit. AU 150 ¶2. [See also ID-24.] Due care includes professional skepticism – "a questioning mind and a critical assessment of audit evidence." AU 230 ¶7. [See also ID-24.] Care and skepticism are particularly important where, as here, the audit is over a high-risk account involving management's estimates. Dearlove, 2008 WL 281105, at *6; Hall and Meyer, 2009 WL 4809215, at *7; cf. AU 342 ¶4 (explaining "when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors" given the "potential for bias in the

subjective factors"). Simply put, "areas that present more risk will demand more attention." Dearlove, 2008 WL 281105, at *29.

Auditors are also required to obtain sufficient competent evidential matter. [ID-25.] Auditors must be "thorough in [their] search for evidential matter and unbiased in its evaluation." AU 326 ¶25; see also AU 328 ¶3 ("The auditor should obtain sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP."). The auditor is to "consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." Id. Further, greater weight is given to independent evidence gathered directly by the auditors. AU 326 ¶21. By contrast, management representations, while part of the audit evidence, "are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU 333 ¶2; see also James Thomas McCurdy, Admin. Proc. File No. 3-10509, 2002 WL 1841565, *8 (Aug. 13, 2002) ("It is axiomatic that an auditor should not rely solely on management representations.").

Finally, auditors are to consider market conditions when auditing fair value estimates. Auditors must "pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information." AU 328 ¶29. And where, as here, fair value measurements are based on appraisals that are dated well before the year-end financial statements, an auditor must "obtain[ ] evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date." AU 328 ¶25.

b. **Respondents' Audit Fell Short of Professional Standards.**

The ALJ correctly found that Respondents' substantive audit of the FAS 114 portion of the ALLL violated these standards. [ID-30-31; see also ID-13-17.] The audit workpapers described the procedures Respondents performed in a "FAS 114 memo," as well as included the individual FAS 114 loan templates TierOne prepared and the auditors reviewed. [DX-120, KPMGTO0005482-5548.] Aesoph explained that the memo and templates were where he expected the engagement team to document the procedures and evidence concerning the FAS 114 loans, and further noted that, if a procedure was important, he would have made sure it was documented in the memo. [DF 313, 315, 354-55.]

The FAS 114 memo described five basic procedures performed: (1) ticking, tying, and confirming the basic calculations; (2) referencing prior period test work; (3) obtaining a sample of appraisals used to value the underlying collateral to assess whether they were within the past 12 months and, if not, inquiring of management whether a discount was necessary or appropriate; (4) discussing the FAS 114 calculations with TierOne's special assets executive; and (5) "leveraging" other loan review work. [ID-14-15; DX-120, KPMGTO0005482.]

The primary procedure ostensibly aimed at the critical risk that collateral values were overestimated (and thus losses underestimated) was procedure 3. But as the ALJ properly found, the procedure was insufficient. [ID-31.] Despite the precipitous market declines throughout 2008, Respondents assumed that so long as an appraisal was dated within the past 12 months, it was "current" and no additional test work was needed. [DX-120, KPMGTO0005482.] Respondents made this assumption despite their awareness of the disastrous economic climate in 2008, which had devastated markets where the bulk of TierOne's FAS 114 loans were located. [ID-14; DF 97, 132-137, 279, 295.] Critically, the effect of this assumption was to pass on any

further scrutiny of tens of millions of dollars in loans with appraisals less than a year old, and instead to presume those appraisal values were still reasonable. [See DF 32.] Moreover, the assumption was inconsistent with TierOne's lending policy, of which Respondents were aware, which stated that in a rapidly deteriorating market, an appraisal may be valid for only a few months [DF 77-78, 338.] The assumption also flew in the face of TierOne's overall ALLL memo, which both Respondents reviewed, stating that Nevada appraisals on certain loans would be discounted if older than six months (even though, in reality, many were not). [DF 172; see also DF 26 (noting age of Nevada appraisals and discounts applied).] Simply presuming that stale appraisals on a high-risk group of loans were a reasonable estimate of value is the definition of a cursory audit procedure, does not reflect appropriate care or skepticism, and fails to constitute sufficient competent evidence.

Further, even if an appraisal was older than a year, the only additional evidence the auditors gathered was "inquir[y]" of management about whether a discount was applied and if not, why not. [DX-120, KPMGTO0005482; see also DF 160, 221, 317.] Inquiry is the least reliable form of audit evidence. [DF 400.] It was particularly inappropriate in this high-risk area, and even more so given that Respondents specifically identified a risk of fraud, i.e., a risk that management may intentionally misstate the ALLL. [DF 406.]

The other procedures similarly failed, individually or collectively, to constitute sufficient audit procedures. [See ID-15-16; 31.] For example, procedure 2 explained that the auditors tied information to prior period test work. But, as Bennett acknowledged, the auditors were required to assess the reasonableness of the losses as of December 31, 2008, regardless of the prior work done. [DF 151.] And perhaps most notably, Respondents' description of their prior period work demonstrated their incredible lack of attention to the realities affecting this audit area.

Respondents' workpapers claimed that, even though TierOne had not made significant changes to its FAS 114 calculations since the prior periods, "***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.***" [DX-120, KPMGTO0005483 (emphasis added); see also ID-15, 31.] Despite attempting to disclaim this language at the hearing [see ID-15; DF 321, 168], the statement clearly underscores Respondents' lack of care.

Similarly, procedure 5 – "leveraging" loan reviews – did not add much, if anything, since very few of the loan reviews involved FAS 114 impaired loans. The FAS 114 memo stated the auditors leveraged reviews by: the KPMG audit team; KPMG's credit specialist, Sandra Washek; and TierOne's Internal Audit department. [DF 169.] However, none of the loans reviewed by the KPMG audit team, and only one of the ten borrowers reviewed by Internal Audit, were impaired at year end. [DF 170.] And of the 28 loan reviews performed by Washek, many of which were performed early in the year, only seven were of loans that were impaired at year end. [DF 170.] What's more, Washek's primary responsibility was to review risk ratings, which primarily impacted the FAS 5 loans, the other portion of the ALLL account. [DF 171; see also DF 62.] While she reviewed the high-level FAS 114 methodology, she did not assess the fair value of the collateral or other assumptions underlying FAS 114 loans, nor did she audit the discounts to appraisals – that was the responsibility of Respondents and their engagement team. [DF 171, 318, 320.] In short, the handful of loan reviews performed throughout the year, done almost exclusively by a person who did not assess the critical components of FAS 114 loan losses, were insufficient to provide audit evidence of the reasonableness of the FAS 114 portion of the ALLL at year-end.

Importantly, as the ALJ properly found, the FAS 114 templates do not reveal any materially different procedures or evidence than that outlined in the FAS 114 memo. [ID-16.] That is, the templates indicate the auditors ticked, tied, and recalculated the FAS 114 calculations, in some cases obtained the underlying appraisal and "agreed" the appraisal value to the value recorded in the FAS 114 template, and in other cases document the results of management inquiry regarding older appraisals. [DF 517.] The templates do not disclose any additional audit procedures or evidence to support Respondents' audit conclusions. Moreover, when questioned extensively about individual templates at the hearing, Respondents could not identify any specific evidence to support the conclusion that TierOne's use of stale, undiscounted appraisals was reasonable at year-end 2008. [ID-17, 31; see also DF 186-231, 330-341.]

In sum, the ALJ correctly found that Respondents' basic audit procedures performed and minimal evidence gathered were insufficient in this high risk audit area. [ID-31.]

2. **Respondents' *Post-Hoc* FAS 157 Argument Does Not Save Their Deficient Audit.**

Rather than attempting to explain how their documented procedures were sufficient, both at the hearing and on appeal Respondents insist that their audit was acceptable because of several purportedly critical, yet plainly undocumented, procedures. Key among them is their supposed reliance on FAS 157. This substantial focus on undocumented work only highlights the cursory nature of the audit: as the ALJ observed, the fact that Respondents "distanced themselves from the [FAS 114] memo, pointing to undocumented considerations and procedures, ... underscores the deficiency in the procedures as documented." [ID-31]

The lynchpin of Respondents' appeals is that the ALJ misinterpreted FAS 157's pronouncements on fair value accounting. [See, e.g., AB-1 ("While the Decision is objectionable on many grounds, its incorrect reasoning and analysis nearly all flow from a fundamental

misconception of fair value accounting ...."); BB-3.] Respondents' argue that according to FAS 157, fair value measurements must exclude "distressed" transactions, and thus at year-end 2008 – during the Great Recession – it would have been inappropriate to look to updated appraisals or market price indices to assess the fair value of FAS 114 collateral. For this reason, Respondents now claim, they were comfortable with TierOne's repeated use of stale appraisals that did not reflect market declines to calculate FAS 114 loan losses.

Respondents' arguments should be rejected for two independent reasons. First, there is no evidence, beyond Respondents' self-serving testimony, that they considered FAS 157 in any meaningful way in auditing the FAS 114 portion of the ALLL. Second, even if they had engaged in the FAS 157 analysis they now proffer, their interpretation of the standard is wrong.

a. The ALJ Correctly Found FAS 157 Was Not a Part of Respondents' Audit Procedures.

To read their briefs, one would think Respondents' FAS 114 audit was replete with references to and analyses based on FAS 157 and that the ALJ took issue with Respondents' interpretations at the time of the audit. In reality, FAS 157 was wholly absent from Respondents' audit, and indeed from their defense, until their expert witness introduced the issue a few weeks before trial. Put simply, the ALJ did not have to interpret FAS 157 at all; she correctly found that "[t]he record belies Respondents' assertion that, in evaluating TierOne's FAS 114 estimates, they conducted any sort of review consistent with their proffered interpretation of FAS 157." [ID-33.]

For example, there is no documentation in the FAS 114 memo or the FAS 114 templates that FAS 157 was a basis for any audit conclusions, let alone conclusions about the reliability of appraisals or market data. [DX-120, KPMGTO0005482-5548; see also DF 261-262.] In addition, Respondents' separate, comprehensive workpaper on FAS 157 – tellingly, a workpaper that Bennett did not know existed at the hearing – makes no mention of FAS 114 or the ALLL. [RX-

4, KPMGTO0004027-4071 (FAS 157 workpaper); see also Tr.-551:4-5 ("[W]e don't have a separate workpaper on FAS 157."); DF 264-265, 356.]

This lack of documentation is critical. As explained above, proper documentation is central to good auditing, and the absence of documentation casts doubt on whether a claimed procedure was actually performed. Moreover, Respondents expressly acknowledged their awareness of the importance of the audit documentation standards. [See ID-11.] Aesoph acknowledged that any competent auditor would follow those standards, and explained that he ensured the engagement team adequately documented the evidence they relied upon to make their audit judgments. [DF 272, 353.] Similarly, Bennett instructed his audit staff that they must document the procedures performed, evidence obtained, and conclusions reached, and that the audit documentation must clearly demonstrate that the work was in fact performed. [DF 58-59.] Indeed, Bennett testified that "***all of th[e] work***" the auditors did to review and test management's loan loss estimation process was documented. [Tr.-714:6-12.] Respondents' own concessions regarding the importance of documentation make clear that they did not employ any sort of FAS 157 analysis or procedure during the course of their audit.

Other evidence further corroborates that Respondents' current FAS 157 interpretation was not something they relied on during the audit. For example, at the time of the audit, KPMG told TierOne, not that updated appraisals were likely unreliable due to the increase in forced sales, but rather that current appraisals were the best indicator of fair value. [DF 263.] Similarly, there is no evidence that TierOne or KPMG rejected or adjusted an appraisal in late 2008 or early 2009 because of concerns the appraisal did not reflect fair value; to the contrary, TierOne continued to accept appraisals and used those appraisals to estimate fair value. [DF 238-240, 296-297, 464-465.]

As telling as the absence of any reference to FAS 157 during the audit is the absence of any reference to FAS 157 in this case until shortly before the trial began. Neither Respondent referenced FAS 157 in numerous days of investigative testimony – testimony which Bennett claimed was given to "help [the Division] understand the things that we did during the audit." [Tr.-1518:21-1519:3; DF 258-260, 357, 359.] Instead, during his ten days of investigative testimony, Bennett repeatedly stated that the best, most persuasive evidence of fair value is a current appraisal. [DF 181; 255-256.] To explain this, Bennett claims he did not have the concept of FAS 157 in his mind during his investigative testimony; Aesoph argues he was not asked the right questions to elicit a response about FAS 157. [DF 257, 357, 359.] The idea that FAS 157 was, as Respondents now claim, critical to their audit conclusions, but they simply failed to mention it during days of investigative testimony, strains credulity.[6]

Similarly, although Respondents' Wells submissions discussed FAS 114 collateral valuation, neither mentioned FAS 157 or their current claim that appraisals and market indices were not reliable determinants of fair value. [DX-229, 21-26; DX-230, 14-15.] To the contrary, Aesoph's Wells submission embraced the market price indices he now claims were unreliable. Aesoph argued that he used market price indices to "assess the reasonableness of management's assumptions relating to the collateral estimates," and that those indices "provided comfort that management's estimates were carefully constructed." [DX-229, 23.] That position is plainly at odds with Aesoph's current argument that he and Bennett "understood that the declines in the market price indices ... actually *overstated* declines in fair value." [AB-14.]

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[6] Respondents' attempt to explain away their prior testimony by claiming they repeatedly used the term "fair value" is equally incredible. [AB-19; BB-34 n.13.] Regardless of terminology, Bennett did not express in his investigative testimony the concept that market indices were not good measures of fair value, or that appraisals were less relevant, because of FAS 157. Rather, he repeatedly testified that current appraisals are always the best evidence of fair value. [See Tr. 1700:1-1701:4.]

Indeed, the genesis of Respondents' FAS 157 argument was in response to these statements in Aesoph's Wells submission. The Division set out to test Aesoph's proposition by retaining an economist, Dr. Anjan Thakor, to do what Respondents claimed they had done – compare market data to collateral values. [DF 2.] Dr. Thakor's analysis found, not that the indices "provided comfort that management's estimates were carefully constructed," but rather that management's estimates were entirely inconsistent with market data and those estimates greatly overstated collateral values. [See generally DX-191 (Thakor report).] Faced with Dr. Thakor's report, Respondents' pivoted, arguing for the first time, through a retained expert witness, that comparison of collateral values to market indices would be "inappropriate." [RX-43A, 3.] The timing of Respondents FAS 157 argument exposes what a red herring it is.[7]

In sum, the ALJ properly noted that Respondents had not based their audit decisions on the interpretation of FAS 157 they now proffer and thus rejected the *post-hoc* attempt to justify their conduct. [ID-18-19, 32-33.] That conclusion is supported by overwhelming record evidence. Respondents' FAS 157 argument should be rejected by the Commission as well. See McNeeley, 2012 WL 6457291, at *11 (rejecting auditor's "after-the-fact rationalization" for audit conduct that was not supported by record evidence); S.W. Hatfield, CPA, Rel. No. 34-69930, 2013 WL 3339647, *20-21 (2013) (rejecting argument that procedures were not required based on audit standard, when the record did not indicate auditors actually considered standard during the audit, as "simply an after-the-fact excuse").

[7] For the same reasons, Respondents' attack on the ALJ's decision to admit Dr. Thakor's testimony should be rejected. [AB-34-35; BB-29 n.10.] The ALJ did not err by admitting an expert who re-performed an analysis Respondents claim they had performed during the audit. The attack on Dr. Thakor for not excluding "forced transactions" from his analysis is particularly unfounded, as it is undisputed that Respondents did not make any such adjustments during their review of the indices during the audit. [DF 254, 280.]

b. The ALJ Correctly Interpreted FAS 157.

Although the Commission need not assess Respondents' interpretation of FAS 157, since it did not inform their audit procedures, in fact their interpretation is incorrect. Respondents argue that FAS 157 permitted TierOne to use appraisals from early 2008, when the markets were "more stable," to assess fair value at year end. [AB-17, BB-34.] Essentially, their argument is that because FAS 157 does not consider a forced transaction "determinative" of fair value, it therefore sanctioned ignoring dramatically declining market conditions because those markets contain distressed transactions. FAS 157 says no such thing.

As the ALJ correctly noted, FAS 157 does not suggest that market conditions can or should be ignored. [ID-33.] FAS 157 defines fair value as "the price that would be received to sell an asset ... in an orderly transaction between market participants at the measurement date." [RX-45, ¶ 5.] Contrary to the interpretation Respondents' expert offered – that FAS 157 requires assuming "a hypothetical transaction ***in an orderly market***" [DF 454] – the standard proposes that the hypothetical transaction itself is orderly, but that transaction is exposed to the actual market, whatever that market is. [RX-45, ¶ 7; see also id. ¶ C25 ("[T]he transaction to sell the asset ... is an orderly transaction, not a forced transaction ... ***that assumes exposure to the market*** ....") (emphasis added).] Put another way, FAS 157 does not ignore market realities, as Respondents suggest, but rather embraces those realities by noting that the hypothetical sale to be fair-valued must be exposed to the current market. Thus, even if Respondents had performed some sort of FAS 157 analysis, they would not have been justified in using that guidance to ignore market conditions and assume that TierOne's stale, undiscounted appraisals were reasonable estimates of fair value at year end.

Bennett also argues that the ALJ misinterpreted FAS 157 by requiring the auditors to obtain "current" appraisals in order to issue a clean audit opinion. [BB-3, 16, 33.] But the ALJ did not find (and the Division did not argue) that current appraisals were required. Rather, the ALJ correctly ruled that, since TierOne was not using updated appraisals, Respondents needed to obtain sufficient, competent evidence that TierOne's loss estimates based on stale, undiscounted appraisals were reasonable – something they failed to do. Whether FAS 157 creates "skepticism" of updated appraisals in a down market, as Bennett argues, it certainly does not eliminate the basic requirement of gathering competent evidence to support audit conclusions.

3. Respondents' Other Undocumented Procedures Do Not Save Their Deficient Audit.

Respondents point to two other undocumented procedures: a supposed review of TierOne's FAS 114 loan files [e.g., AB-17, 37, 42; BB-27]; and a supposed conversation with TierOne's controller about TierOne's 30% loan loss taken throughout the year on Nevada loans [e.g., AB-14, 21-22; BB-29-30]. While equally suspect due to the Respondents' failure to document them, as the ALJ correctly found, these purported procedures did not save the deficient audit. [ID-18-20, 32-33.]

a. Respondents' Purported Review of Loan Files Did Not Provide Competent Evidence that TierOne's Collateral Valuations Were Reasonable.

The ALJ properly found that Respondents' purported loan file review was undocumented, and that even if it had occurred, Respondents had not demonstrated how the review amounted to sufficient, competent audit evidence. [ID-18.] As an initial matter, despite now claiming this review was "vital audit evidence" [AB-37], Respondents have conceded the FAS 114 memo does not document that the auditors obtained or reviewed loan files. [DF 164-166, 364.] As noted above, Respondents conceded the importance of the audit documentation

standards, and Bennett claimed all the work performed was documented. The lack of documentation alone casts serious doubt on whether the procedure actually occurred.[8]

Moreover, as the ALJ also correctly noted, even assuming the review occurred, Respondents did not identify what purported evidence from the loan files could have supported management's estimates of collateral value on the numerous FAS 114 loans with stale, undiscounted appraisals in rapidly declining markets. [ID-32.] Indeed, Respondents were specifically asked about numerous loans, but did not identify any loan-specific evidence to support the collateral valuation estimates. [See DF 186-231, 330-341.] Nor, as a matter of common sense, could they. The claim that there was reliable evidence to support management's assertion that collateral values on numerous properties in hard-hit states had all held their value during the course of the Great Recession is on its face incredible.

Ironically, Respondents now attack ***the Division*** for not obtaining all of the loan files they purportedly reviewed, claiming the Division failed to develop a full investigatory record of what occurred during the audit. [AB-36-37; BB-37 n.15.] But this is precisely why audit documentation is critical: it eliminates later disputes about what an auditor did, and how her procedures amounted to sufficient evidence to support her conclusions. Cf. AS No. 3 ¶6.a ("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,

[8] Aesoph claims the workpapers document over 200 instances in which the auditors reviewed the loan files. [AB-37.] However, nearly all of the "200 instances" are internal control test work that is unrelated to collateral values or losses on FAS 114 loans. [See JPF-451 (citing to workpapers involving control test work for, among other things, loan authorization, loan coding, and assessing fund draws on real estate construction lending).] Respondents' do cite to the FAS 114 templates, but notably fail to explain how those templates show a review of loan files. [See id.] In fact, the templates say nothing about loan files, or any other "corroborating information" from those loan files, but rather reference only that the auditors reviewed the appraisals themselves. [See DX-120, KPMGTO0005484-548.]

and results of the procedures performed, evidence obtained, and conclusions reached ....").
Further, Respondents' attempt to avoid liability by attacking the Division for not obtaining evidence the auditors never documented, but claim they reviewed, would lead to absurd results. Essentially, an auditor could testify at trial about undocumented evidence she purportedly obtained, and then insist that the Division had not met its burden because it did not develop a complete record regarding work it could not have known about during the investigation. Respondents' attempt to use their own violation of the audit documentation standards to challenge the Division's investigatory processes should be rejected.[9]

b. Respondents' Purported Confirmation of Losses in 2008 Did Not Provide Competent Evidence that TierOne's Collateral Values Were Reasonable.

Respondents' final undocumented procedure is a purported conversation with TierOne's controller, David Kellogg, where he allegedly explained that TierOne had recognized losses of approximately 30% on its Nevada loan portfolio throughout 2008 – figures the auditors' purportedly corroborated. [AB-3, 9, 14, 16-17, 21-22; BB-29-30.] As with the other undocumented procedures, the Decision correctly found this procedure absent from the workpapers, and insufficient even if it had occurred. [ID-19-20, 33.]

[9] Similarly, the fact that the Division's accounting expert, John Barron, did not review the loan files was not a "shortcoming" in his work. [AB-26; BB-19 n.4.] As Barron explained during the hearing, he did not review the loan files because there was no documentation in the workpapers that Respondents did so. [Tr.-1201:21-1202:21; see also Tr.-1196:16-18.] It was entirely appropriate for Barron to base his opinions on the documented audit. See AS No. 3 ¶6.a.

Aesoph also excerpts a portion of Barron's testimony to argue that Respondents consulted loan files. [AB-37.] But in context, Barron's testimony makes clear that, although he was not taking issue with Respondents' testimony that they looked at loan files, he could find no indication of how the auditors used that (or any other) information to actually assess the reliability of the collateral values used on numerous FAS 114 loans. [Tr.-1327:23-1328:21; see also Tr.-1326:10-1327:10.]

As a threshold matter, Aesoph now makes the incredible claim that "[t]he conversation with Mr. Kellogg was … documented." [AB-22.] Perhaps most damning to this argument is Respondents' own testimony, where they expressly admitted the conversation was not in the workpapers. [Tr.-1787:15-18 (Aesoph testimony) ("Q: And it's fair to say, though, that the Kellogg conversation is not documented in the workpapers, right? A: It is not, no."); see also Tr.-1695:1-4 (Bennett testimony) (agreeing that "nowhere in the workpapers does it document this conversation with Mr. Kellogg"); DF 174, 176, 178, 180, 244, 362.] Moreover, neither Aesoph nor Bennett mentioned the purported Kellogg conversation or corroborating procedures in their investigative testimony or Wells submissions. [DF 181-184, 363.] Respondents' creative arguments notwithstanding, they have conceded these procedures were not documented.

Respondents attempt to avoid their admissions (and the plain text of the workpapers) by arguing that the 30% loss recognition was "plainly evident" from records included in the workpapers. [AB-22; see also BB-30.] Essentially, their argument is that because someone could calculate TierOne's loss recognition from a schedule found in another section of the workpapers, the ALJ erred in finding the procedure undocumented. But this argument hurts Respondents rather than helps them. That one could easily calculate the loss recognition makes it all the more troubling that such a calculation was not in fact recorded. See AS No. 3 ¶6 ("Audit documentation must clearly demonstrate that the work was in fact performed.").

Further, the ALJ correctly found that even if the Kellogg conversation had occurred, it was not sufficient evidence of the reasonableness of TierOne's FAS 114 estimates at year end. [ID-19-20, 33.] Put simply, the timing of TierOne's 30% loss recognition was inconsistent with market trends. TierOne's losses were heavily weighted toward the first half of the year, even though the market declines occurred primarily in the second. [DF 411; see also DF 348.] Further,

nearly all of the losses in the second half of the year were related to two loans designated as "impaired" for the first time in the third and fourth quarters. [DF 366.] Excluding those loans, TierOne's loss recognition in the second half of the year was nearly non-existent. [DF 366, 411.] As Aesoph himself acknowledged, the fact that loss provisions may have been recognized with respect to a particular loan does not mean that losses did not need to be recognized for other impaired loans, since loss recognition is a loan-by-loan analysis.[10] [DF 367.] And finally, an examination of TierOne's loss recognition outside of Nevada – which was largely inconsistent with market trends, and heavily skewed to the first half of the year – belies the claim that Respondents could have taken comfort in the supposed consistency between market trends and losses. [DF 412-415.] For all of these reasons, the ALJ properly found that this undocumented procedure did not amount to competent audit evidence that management's FAS 114 estimates were reasonable at year-end.[11]

As with the undocumented loan file review, Aesoph again argues that not crediting the undocumented Kellogg conversation shifted the burden of proof to Respondents. [AB-22.] And again, this is simply not the case. The Division proved its case by showing that the procedures described in the audit workpapers were insufficient. Forcing the Division to ***disprove*** that undocumented procedures occurred in order to meet its burden of proof would turn notions of

[10] For this same reason, Bennett's claim that Respondents took comfort in seeing that management identified other loans as impaired and received appraisals on non-Nevada FAS 114 loans could not have provided Respondents comfort that the FAS 114 portion of the ALLL was reasonable, since numerous loans with collateral in the hardest-hit markets were still valued using stale, undiscounted appraisals. [See BB-31, 36.]

[11] In addition, Respondents' loss recognition argument is inconsistent with their FAS 157 argument. If a "disorderly market" is to be disregarded, as the Respondent's contend, there would presumably be no reason for the Nevada loan portfolio to be discounted by the amount the market declined.

proof on their head. It would also provide a roadmap for any auditor to defeat a 102(e) charge with self-serving testimony at a hearing. Respondents' tactics should not be condoned.

* * * * *

In sum, Respondents' unyielding reliance on undocumented procedures – the supposed FAS 157 analysis, the supposed loan file review, and the supposed conversation with Kellogg – cannot rescue their deficient audit. Moreover, Respondents' focus on what is ***not*** documented is a tacit admission of the insufficiency of what ***is*** documented. Indeed, comparing the procedures described in the workpapers with the procedures Respondents now claim they performed demonstrates just how far Respondents have stretched in an effort to try to explain away their cursory audit work. Compare FAS 114 memo (DX-120, KPMGTO0005482), with, e.g., AB-7-9; BB-26-32. Respondents should be judged by the audit that is documented, and the Commission should affirm the ALJ's well-reasoned analysis finding that audit insufficient.

4. Many of Respondents' Additional Arguments are Precluded By Their Admissions.

In addition to hanging their defense on undocumented procedures, Respondents raise numerous arguments that are directly contradicted by their previous admissions. For example, Respondents attack the Decision for focusing too heavily on the procedures in the FAS 114 memo, rather than looking outside of that document for audit work done. [BB-3; AB-18, 20.] Putting aside the fact that the memo expressly states that it "document[s] KPMG's procedures to audit the FAS 114 calculations," [DX-120, KPMGTO0005482], Aesoph conceded that the FAS 114 memo and templates are where he expected the relevant procedures and evidence to be documented. [ID-14; DF 355; see also id. 313, 315, 354.] The Decision did not err by focusing on that portion of the workpapers.

Similarly, Respondents attempt to minimize the importance of the FAS 114 portion of the ALLL by arguing it is only one part of the overall ALLL account. [See BB-6, 11; AB-32; see also AB-26 (criticizing Division's accounting expert for "ignor[ing]" FAS 5).] However, Respondents and their accounting expert conceded that the FAS 114 portion of the ALLL was individually material – without respect to the FAS 5 portion – to TierOne's financial statements. [DF 138, 294, 482.] Moreover, Aesoph acknowledged that Respondents needed to perform sufficient audit procedures over, and obtain persuasive evidence supporting, the FAS 114 portion of the ALLL, and if Respondents failed to do either of those things "then KPMG would not have a reasonable basis to render its audit opinion." [Tr.-1800:20-1801:11; see also ID-12.] Any attempt to minimize the importance of the FAS 114 portion of the ALLL should be rejected.

Respondents also argue the Decision improperly held them to a standard of auditing individual loans. [BB-17, 35; AB-31-32.] But the Decision did not purport to require an "audit" at the individual loan level; it found only that, "in order to evaluate the reasonableness of the estimates in the context of the financial statements taken as a whole, [Respondents] were required to evaluate those estimates on a loan-by-loan basis." [ID-3-4.] That conclusion was based on Respondents' concessions. Bennett testified that the auditors reviewed the loss estimates on a loan-by-loan basis, and indeed such an approach "was required by FAS 114." [Tr.-499:4-10; see also Tr.-539:24-25 (stating that "FAS 114 required us to evaluate loans on a loan-by-loan basis"); Tr.-577:2-5 (agreeing that, "in the audit of the FAS 114 loans, [the auditors] look at it on a loan-by-loan basis").] Similarly, Aesoph agreed that "KPMG audited the[ ] [FAS 114] templates and the[ ] [FAS 114] loans on a loan-by-loan basis," and indeed had to do so "[b]ecause determining fair value is a loan-by-loan, case-by-case analysis." [Tr.-850:16-851:3.] Respondents' argument that the ALJ improperly applied accounting standards, when she

based her findings on Respondents' explicit admissions of how they performed the audit, should be given no weight.

At bottom, Respondents' attempt to walk away not only from their audit workpapers, but also from their own admissions at trial, further exposes their appellate arguments as *post hoc* rationalizations that should be summarily rejected.

5. Respondents Improperly Rely on Numerous Procedures Unrelated to the FAS 114 Loans.

Respondents also cite to numerous audit procedures that are not relevant to the FAS 114 portion of the ALLL. For example, Respondents cite to Sandra Washek's loan reviews and assessment of FAS 114 methodology. [BB-13, 26; AB-6.] However, as noted above, very few of Washek's loan reviews were of FAS 114 impaired loans. And while Washek did review TierOne's high-level FAS 114 methodology, she did not assess the fair value of the collateral or other assumptions underlying FAS 114 loans, nor did she audit the discounts to appraisals. [DF 171, 318, 320.] Washek's work adds little, if anything, to the Respondents' procedures and evidence relating to the FAS 114 portion of the ALLL.

Respondents also note TierOne's engagement of an outside firm to review loans. [AB-9; BB-12.] However, that firm – the Reynolds Williams Group – was employed primarily to review risk ratings, which, as noted above, affected the ALLL on FAS 5 loans. [DF 267; see also DF 62.]

Respondents – particularly Bennett – also point to KPMG's concurring review partner, Terrence Kenney. [BB-13; AB-7.] But while Kenney did sign off on certain workpapers, including the overall ALLL memo and the FAS 114 memo, he did not provide any material guidance to Respondents about collateral values, the age of appraisals, or whether appraisals should be discounted. [DF 495-497, 500-502.] Nor did Kenney recall reviewing the detailed

workpapers where the engagement team would have documented their assessments of management's conclusions around appraisals and discounting. [DF 498.] Bennett himself acknowledged that Kenney did not review the individual FAS 114 templates or comment on any specific FAS 114 loans. [DF 245-246.] And Aesoph expressly conceded that Kenney could not provide the auditors comfort that the FAS 114 collateral values were correct at year-end. [DF 344.]

In sum, Respondents cannot save their deficient audit over the high-risk, individually material FAS 114 portion of the ALLL by reference to other procedures that are, at best, tangential to their work on that account.

C. The ALJ Correctly Found that Respondents' Audit of Internal Controls Violated Professional Standards.

1. PCAOB Standards: Auditors are to Identify and Test Controls in Areas of Highest Risk.

Like substantive testing, risk assessment drives the audit of internal controls, "including the determination of significant accounts, ... the selection of controls to test, and the determination of the evidence necessary for a given control." AS No. 5 ¶10. Put more simply, "[t]he auditor should focus more of his or her attention on the areas of highest risk." AS No. 5 ¶11. The auditor's goal is to obtain sufficient evidence to obtain a reasonable assurance that there are no material weaknesses – deficiencies that create a reasonable possibility that a material misstatement will not be prevented or detected. AS No. 5 ¶3 & Appx. If one or more material weaknesses exist, the auditor cannot issue an unqualified opinion. AS No. 5 ¶¶2, 90.

2. The Control Respondents Identified to Address the Risk of Collateral Overvaluation Did Not Sufficiently Address the Risk.

The ALJ correctly found that, despite identifying collateral overvaluation as a specific risk point, the only control Respondents identified related to that risk did not in fact address it.

[ID-26-28.] Respondents' acknowledge that the risk that collateral securing loans may be overvalued related specifically to the FAS 114 loans. [DX-120, KPMGTO0005188; DF 140, 304.] The sole control identified to address this risk was denoted "Lot 7-2, Appraisal Review." [DX-120, KPMGTO0005188.] However, it is undisputed this control related to the review of appraisals when they were received, not whether the appraised values were still reasonable – and thus collateral not overvalued – at year end. [DF 142, 305.] Without a control addressing the risk that the ALLL was understated because collateral was overvalued at year end, Respondents lacked a reasonable basis to conclude no material weaknesses existed and, thus, to issue an unqualified audit opinion. [ID-28.]

Respondents contend that the Appraisal Review control was only intended to address the risk that there was not adequate collateral at the "front end," when loans were originated, rather than any "back end" risk that the valuation was too high later in the life cycle of the loan. [BB-21; AB-28.] But this argument exacerbates, rather than cures, the problem. The risk of collateral overvaluation at year-end was pronounced: TierOne routinely relied on stale appraisals, the markets were plummeting, and the OTS's increased capital ratios gave TierOne an incentive to understate losses. Indeed, Aesoph specifically conceded that there was a risk of collateral overvaluation due to stale appraisals at year-end 2008. [Tr.-805:16-23.] The fact that the only control identified to address the risk of collateral overvaluation was not focused on that valuation at year-end only highlights the deficiencies in Respondents' audit. [See ID-28.]

Respondents also argue that there were other controls aimed at collateral valuation issues. For example, Respondents insist that TierOne's controller independently reviewed the FAS 114 templates, and that this served as a reasonable control addressing the risk of collateral overvaluation. [AB-29 (discussing the "Finance Department (Controller) Reviews FAS 114

Templates" control); see also BB-22, 24-25.] Respondents fail to mention, however, that this was not a control they identified or tested during their audit of the ALLL. [DX-119, KPMGTO0005029-31 (memo documenting controls KPMG independently tested).[12]] Respondents cannot satisfy professional standards by pointing to controls they did not test. See AS No. 5 ¶22 ("The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."). This is yet another *post hoc* argument that should be rejected.

Respondents further point to the review of the ALLL by TierOne's high-level Asset Classification Committee. [AB-30-31; BB-22, 25.] However, as the ALJ properly found, this review did not specifically address the risk that collateral associated with FAS 114 loans may be overvalued. [ID-28.] As a threshold matter, Respondents did not identify this control as addressing the collateral valuation risk. [DX-120, KPMGTO0005188.] Further, whatever data the ACC reviewed, it did ***not*** review the FAS 114 templates or otherwise test the calculations or assumptions relating to the FAS 114 loans. [DF 145, 309-310.] The ACC's review was not intended to, and did not sufficiently, address the specific risk of collateral overvaluation.

In short, regardless of Respondents' other audit work testing other ALLL controls, the fact remains that Respondents identified only one control aimed at the critical risk that collateral

[12] Documentation of the controller review of the FAS 114 template appears only in a listing of TierOne's FDICIA/Section 404 internal control assessment, which is contained in KPMG's binder of materials management provided them, not in the workpapers describing KPMG's audit work over the ALLL. [RX-2, KPMGTO0003021-32, at 3027; see also JPF-279.]

Bennett cites to a portion of the Internal Control workpaper addressing management's review of the ALLL for the proposition that "[t]he engagement team documented that Mr. Kellogg, as Controller, reviewed the ***FAS 114 templates*** as an internal control over the estimation process for impaired loans." [BB-22 (citing DX-119 at KPMGTO0005056).] The workpaper says no such thing. Rather, the workpaper notes that "[t]he Controller reviews the ***ALLL calculation*** included in the quarterly binder." [DX-119, KPMGTO0005056.]

may be overvalued, and that control did not address the risk at year end. Having failed to identify a control to address a critical risk, Respondents failed to obtain competent evidence to get reasonable assurance about whether a material weakness existed.

D. The ALJ Correctly Found That Respondents Violated PCAOB Standards by Engaging in No Review Under AU 561.

1. PCAOB Standards: Auditors Must Follow Up on Facts Which Might Have Affected Their Audit Opinion.

Audit standard AU 561 provides certain procedures that auditors should follow when, subsequent to the date of the audit report, they discover facts that "may have existed at that date" and which "might have affected the report." AU 561 ¶1. As an initial step, if that information is "of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit," the auditor should "undertake to determine whether the information is reliable and whether the facts existed at the date of his report." Id. ¶4. Specifically, the auditor "auditor should discuss the matter with his client at whatever management levels he deems appropriate ... and request cooperation in whatever investigation may be necessary." Id. If, after this investigation, the information is deemed reliable, even more is required if the audit report would have been affected by the subsequently discovered facts. Id. ¶5.

2. Respondents Failed to Perform *Any* AU 561 Review.

Shortly after the issuance of KPMG's March 2009 audit report, Respondents learned of new appraisals on certain Nevada FAS 114 loans that were dated in January and February 2009. [ID-34; DF 233-236.] Two of these appraisals reflected multi-million dollar declines in the collateral values TierOne used in preparing its year-end financial statements, which were based on appraisals from late 2006 in one case and early 2008 in the other. [DF 234, 236.] As a result

of the new appraisals, TierOne recognized $3.6 million in additional losses in the first quarter 2009. [ID 34-35; DF 233-236.]

The early 2009 appraisals, which existed at the time of the audit report, were undoubtedly facts Respondents would have investigated had they known of them: Bennett acknowledged that TierOne needed to consider any appraisal received after December 31, 2008, but before the date of the financial statements, to assess whether the appraisal affected the bank's year-end fair value estimates. [DF 232.] Even so, as Aesoph conceded, Respondents performed no evaluation of these appraisals under AU 561. [DF 346-347; see also DF 237.] The ALJ properly found that Respondents' failure to conduct an inquiry violated AU 561. [ID-35.]

Respondents argue that AU 561 was not triggered because the appraisals would not have caused a restatement of TierOne's year-end financial statements. [BB-38-39; AB-33.] Respondents misunderstand the trigger. Respondents cite to paragraph 5 of the standard to claim nothing is required of them unless the subsequently-discovered information "would have … affected" the audit report by leading to a restatement of the financial statements. While paragraph 5 plainly provides what ***further*** action an auditor must take if she concludes the audit report would have been affected, it is by no means the ***trigger*** for AU 561 analysis.

The trigger is set forth at the outset of the standard: "The procedures described in [AU 561] should be followed by the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which ***might have*** affected the report had he or she then been aware of such facts." AU 561 ¶1 (emphasis added). More specifically, AU 561 is triggered whenever an auditor learns of information "which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit." Id. ¶4. As noted above, the appraisals clearly met that

standard. At that point, an auditor must perform some analysis to determine whether the information is reliable, including discussing the matter with management. Id. Only after this analysis is completed can the auditor determine whether the information "would have affected" the audit report and financial statements. Id. ¶5. Put simply, Respondents cannot escape liability for performing no assessment under AU 561 by arguing that, if they had performed the required assessment, they would have concluded a restatement was unnecessary. Their failure to perform any inquiry violated the standard.

E. The ALJ Correctly Found that Respondents Violated Rule 102(e).

Rule 102(e) prohibits negligent conduct: either a single instance of highly unreasonable conduct in an area requiring heightened scrutiny; or multiple instances of unreasonable conduct, each resulting in a violation of professional standards, that indicate a lack of competence to practice before the Commission. 17 C.F.R. § 201.102(e)(1)(iv). [See also ID-22-24.] While Respondents attempt to downplay the significance of negligent conduct, the Commission has emphasized that "a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive." Amendment to Rule 102(e), 63 Fed. Reg. at 57,167. Considering all of the evidence, the ALJ found Respondents engaged in a single instance of highly unreasonable conduct. [ID-36.] As explained in detail above, the ALJ's findings were correct, supported by substantial evidence, and should be affirmed.

Aesoph argues he should not be sanctioned for making difficult judgment calls with respect to TierOne's valuation of its FAS 114 loans. [AB-39-42.] But the evidence shows Aesoph applied very little judgment at all. Instead, he simply accepted any appraisal a year old or less as "current," and did nothing more than inquire of management when appraisals exceeded that limit. Moreover, any "judgment" he applied was decidedly mistaken: he relied on prior-

period procedures because, he claimed, "***market conditions have not materially deteriorated***" throughout the year, a conclusion that was plainly inconsistent with reality. [DX-120, KPMGTO0005483 (emphasis added); see also ID-15, 31.] This is not a case where an auditor thoughtfully made a considered judgment call, but got it wrong. Rather, Respondents applied no real judgment in an area of significant risk and in the face of serious red flags, instead resting on a cursory review of stale appraisals and inquiry of management. Such conduct is a significant departure from professional standards.

Bennett argues that the ALJ made "no effort" to explain what Respondents' highly unreasonable conduct was. [BB-40.] This argument ignores the Decision's clear assessment of Respondents' actions:

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

[ID-36.] This conduct, which violated basic audit standards requiring due care, professional skepticism, and competent evidence, plainly rises to the level of highly unreasonable conduct. See James Thomas McCurdy, Rel. No. 34-49182, 2004 WL 210606, *8-9 (Feb. 4, 2004) (failure to "undertake ... simple, obvious steps" and obtain competent evidence in an area of heightened scrutiny constituted highly unreasonable conduct).

Bennett further argues he should not be sanctioned under Rule 102(e) because, he claims, it is not clear what else he should have done. [BB-40-41.] But the answer to that question is self-evident: he should have followed basic standards, applied professional skepticism, and gathered sufficient, competent evidence in one of the highest-risk areas of the audit. Bennett's continued

failure to recognize his audit failures – and indeed his argument that his conduct was not only acceptable, but exemplary, as there was nothing more he could have done – underscores his lack of appreciation for the core responsibilities of an auditor.

Aesoph also suggests he should not be held liable for improper professional conduct because Respondents' only misconduct involved the FAS 114 portion of the ALLL, and their other audit work met professional standards. [AB-41-42.] The Commission has previously rejected just such an argument. In Dearlove, Commission found a violation of Rule 102(e) even though, the partner argued, "the record contains evidence of [his] 'overall diligence and competence.'" 2008 WL 281105, at *29. The Commission held that "[e]vidence that Dearlove spent substantial time and effort on some auditing areas does not insulate him from liability for his failure to spend enough time and effort on others that were so material to [the company's] financial statements." Id. The same is true here. Whether or not Respondents performed competently in other audit areas, their serious failures to comply with professional standards in auditing a high-risk account constitute improper professional conduct.[13]

Respondents further attack the ALJ's alternative holding that their failings over internal control and in the substantive audit constitute distinct instances of unreasonable conduct that demonstrate a lack of competence to practice before the Commission. [ID-36 n.38; AB-44; BB-41-42.] While Aesoph acknowledges, as he must, that the Commission has rejected the argument that there must be misconduct in two discrete accounts to qualify as "repeated instances," see Hall and Meyer, 2009 WL 4809215, at *7, he argues this case is different because it involves "a *subset* of a single account." [AB-44.] Notably, Aesoph cites no case for this proposition. The

[13] Similarly, the fact that the Division's auditing expert, John Barron, did not criticize every aspect of Respondents' audit conduct does not save them: as Barron reiterated during his rebuttal testimony, he formed and maintained an opinion that Respondents' work over the FAS 114 portion of the ALLL failed to meet professional standards. [Tr.-2238:20-2240:16.]

reasoning of Hall is fully applicable here: whether conduct occurred in one account, or one part of one account, the standard focuses on the number of instances of misconduct, not the accounts in which the misconduct occurred.

Bennett argues – again, without citation to legal authority – that the alternative holding is improper because it is based on the same conduct as the primary holding finding a single instance of highly unreasonable conduct. But there is nothing legally or logically wrong with such a position. Essentially, the ALJ ruled that Respondents' conduct, taken as a whole, met the "highly unreasonable" standard, but even broken down to its discrete parts, each part alone was at least "unreasonable." Such reasoning is not improper. Cf. McNeeley, 2012 WL 6457291, *16 ("Any one of [the] auditing failures would have been highly problematic. But taken together, the failures are especially egregious."). This is particularly true since both analyses prove the same ultimate issue: an auditor's negligence constituting improper professional conduct. 17 C.F.R. § 201.102(e)(1)(iv)(B).

Finally, Respondents contend the Decision "ignores entirely" that Respondents were defrauded by TierOne's management. [AB-4; see also id. at 42; BB-37.] This is simply not true. The Decision directly – and correctly – addressed management's fraud, and noted that it did not excuse Respondents of their responsibility to comply with PCAOB standards. [ID-34.] In McNeeley, the Commission assessed a similar argument, finding that while management was no doubt engaged in fraud, and no doubt providing the auditors with inaccurate information,

> [t]he gravamen of the charge against [the auditor] ... is not her failure to uncover the fraud itself, but her failure to adhere to GAAS during the audit.... Therefore, although we do not know whether the fraud would have been uncovered had [the auditor] fulfilled [her] professional duties in conducting the audit, ... that is not relevant to our inquiry.

2012 WL 6457291, *12 (alternations and quotations omitted); see also id. at *18 (noting that the fraud "did not cause her auditing failures. Her highly unreasonable conduct caused her auditing failures."); Touche Ross & Co., Rel. No. 33-5459, 1974 WL 161425, at *1 (Feb. 25, 1974) (deception did not relieve auditor of its responsibility to perform audits in conformity with GAAS). In short, the proper question in this proceeding is whether the auditors adhered to PCAOB standards based on the information they knew at the time of the audit. The ALJ correctly rejected Respondents' attempt to excuse their cursory review of the evidence they were provided because there was other evidence that management withheld.[14]

IV. CONCLUSION

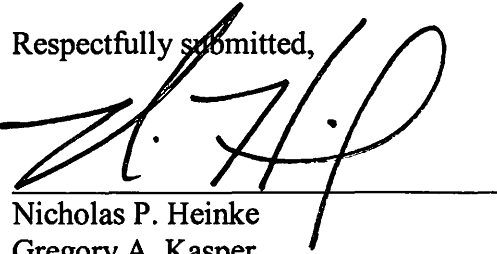
The Commission should reject Respondents' attempt to re-write what occurred during their audit, and affirm the ALJ's well-reasoned findings and conclusions as to their violations of Rule 102(e).

[14] Respondents also argue about appropriateness of the sanctions the ALJ imposed. The Division has addressed the sanctions issue at length in its own opening brief.

Rule 450(d) Certification: Undersigned counsel certifies that the above brief contains 13,927 words, exclusive of the table of contents, table of authorities, and table of record citation abbreviations.

Dated: December 23, 2014

Respectfully submitted,



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Certificate of Service

On December 23 2014, the foregoing DIVISION OF ENFORCEMENT'S OPPOSITION TO OPENING BRIEFS OF RESPONDENTS JOHN J. AESOPH AND DARREN M. BENNETT was sent to the following parties and other persons entitled to notice as follows:

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