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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15168

In the Matter of

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

Respondents.

RESPONDENT JOHN J. AESOPH'S REPLY BRIEF TO THE COMMISSION

January 23, 2015

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I. INTRODUCTION

As Mr. Aesoph's Opening Brief describes in detail, the Initial Decision ("Decision") is objectionable on many grounds, including its failure to consider the applicable fair value accounting standard and guidance, its reliance on the audit documentation standard to justify its dismissive treatment of relevant evidence and testimony, its wholesale failure to weigh the evidence in the context of the trial record, including expert testimony from a member of the Auditing Standards Board that Mr. Aesoph complied with all applicable standards, its erroneous admission of the report and testimony of an unqualified expert, and its decision to sanction Respondents in a case lacking any evidence of unprofessional conduct. Indeed, these fundamental errors threaten the legitimacy of the entire proceeding.

In its Opposition to Mr. Aesoph's appeal, the Division endorses and defends these several errors, and in that process commits several more. Neither the Decision nor the Division can escape the essential focus of this matter on fair value and application of the relevant guidance. By ignoring the Commission's own guidance issued in September 2008, and defending the Decision's misconstruction of fair value accounting, the Division repeats and expands the Decision's own fundamental errors. Indeed, when viewed through the proper framework, the Division appears to go to great lengths to avoid the record and applicable standards in its analysis, which compel a far different conclusion than that reached in the Decision.

Any one of the Decision's errors is an independent ground for reversal. And each highlights the central reason the Decision must be reversed: the Decision reflects a fundamentally unfair proceeding inconsistent with due process and an administrative agency's obligations under the Administrative Procedure Act. Nothing short of Mr. Aesoph's career and livelihood is at stake. In such circumstances, notions of fairness require much more than these proceedings have yielded to date. When Mr. Aesoph's conduct is evaluated as it should be—on the entirety of the record and with applicable accounting and audit standards in mind—no finding of improper professional conduct under Rule 102(e) can follow.

II. The Division and Decision Fail to Recognize FAS 157 as an Accounting Principle That Undeniably Applied to the 2008 Audit

The Division continues to minimize the importance of FAS 157 on the basis of a fatally-flawed legal argument: according to the Division, the ALJ need not consider a particular GAAP standard where the relevant work papers contain repeated references to "fair value" but not to "FAS 157." Opp'n Br. at 23. This argument defies reason.

FAS 157 is an applicable accounting standard. It applied to the financial statements under audit. And it *must* be applied in the ALJ's and Commission's review of the audit. In assessing whether an auditor met professional standards (let alone engaged in improper professional conduct), an ALJ and the Commission must consider the accounting standards applicable at the time of the challenged audit. *See, e.g.*, *Harbrecht*, Exchange Act Release No. 56469, 2007 WL 2726795, at *11 n.7 (Sept. 19, 2007) (applying GAAP standards in effect at the time of the audit in question); AU § 328.15 ("The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP."). If the ALJ and Commission were free to ignore applicable accounting standards, the proceedings would be rendered entirely and fundamentally unfair to auditors who are duty-bound to apply those standards in the audit. The lengths to which the Division goes to avoid FAS 157 only underscore its importance.

A. The Division's Misplaced Focus on "Stale Appraisals" Illustrates Its Fundamental Misunderstanding of Applicable Principles and Professional Standards

In downplaying FAS 157's applicability to the 2008 audit, the Division improperly focuses and expounds upon TierOne's alleged use of "stale appraisals," arguing that appraisals dated in early to mid-2008 were not adequate audit evidence at year-end. But the professional accounting and auditing standards provide no support for the Division's position.

Appraisals provide audit evidence of a fair value estimate for a property at a particular point in time. Auditors assess that evidence in light of management's year-end estimate, including "obtain[ing] 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. In evaluating that evidence in light of management's estimate, auditors assess whether "[m]anagement's assumptions are reasonable and reflect, *or are not inconsistent with*, market information." AU § 328.26 (emphasis added).[1] This is precisely what Mr. Aesoph did.

The Decision reaches a different conclusion precisely because it dismisses FAS 157: the Decision assumes management's estimates were inconsistent with market information because the market information showed prices declining precipitously in the last half of 2008. But the Division conflates AU § 328 with fair value reporting under FAS 157. As expressly noted in the work papers, management attributed those market price declines to foreclosures, and that assumption was not only "not inconsistent with market information" (AU § 328.26), it was entirely supported by the audit evidence.

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[1] The Decision twice overstates the AU § 328.26 standard, both times asserting that management's assumptions *must* be consistent with market data. Decision ("ID") at 13, 33.

1. Mr. Aesoph and His Team Obtained Sufficient Audit Evidence to Assess Changes in Market Conditions

The record shows the audit team obtained significant audit evidence reflecting changes in market conditions[2] subsequent to the dates of the alleged "stale" appraisals, as AU § 328.26 required. Most notably, the auditors reviewed management's L-30A memorandum, a comprehensive evaluation of late-2008 market conditions relevant to each region and loan type. (J.P.F. ¶ 310; Resp'ts Ex. 8 at KPMGTO5432-69.) The auditors obtained and reviewed the third-party market data upon which that analysis was based, including Case-Shiller market price reports, and National Association of Realtors reports. (J.P.F. ¶ 311.) This independent market information was the foundation for the auditors' review and assessment of management's year-end loan loss estimates in the FAS 114 templates.

The significance of the auditors' review of each FAS 114 template and supporting evidence cannot be overstated, yet it is essentially ignored by the Division and Decision. The FAS 114 templates formed the backbone of management's individual impaired loan valuations: they reflected that considerable losses (charge-offs and reserves) already had been recorded on the loans during 2008—to the tune of $57 million on an impaired loan portfolio of only $226 million. (J.P.F. ¶ 121.) The FAS 114 templates estimated fair value of the collateral, selling costs, and a discount for the anticipated holding period, which reflected management's assumption regarding the time it would take to sell a property (generally ranging from 12 to even

[2] The Division's repeated attempt to use one errant sentence ("market conditions have not materially deteriorated") against Respondents is unsupportable. *See* Opp'n Br. at 42. The work papers are replete with references to market deterioration, and the Decision acknowledges the auditors "were fully aware of these market conditions" and accordingly increased their year-end procedures. ID at 12, 30. The Division undermines its own point by admitting elsewhere the auditors were aware "of the disastrous economic climate in 2008, which had devastated markets." Opp'n Br. at 19. Clearly, the sentence was an oversight.

36 months). (J.P.F. ¶ 321.) The loan files obtained in the course of the FAS 114 template review yielded appraisals, credit reviews, loan analyses showing the construction project's current status, and property inspection reports. (J.P.F. ¶ 340.) These loan files—amounting to several "carts" of information—provided a wealth of supporting audit evidence regarding any changes to the particular property between the date of the most recent appraisal and year-end. (J.P.F. ¶ 337.) This evidence, together with the market analysis and corresponding third-party market reports, was the primary audit evidence Mr. Aesoph and his team assessed in determining whether management's loan valuation estimates were "not inconsistent with[] market information" (AU § 328.26), and reasonable in the context of the financial statements.

2. The Audit Evidence Showed Management's Estimates Were Reasonable and Not Inconsistent With Market Information

The Division does not dispute this audit evidence was obtained. Instead, it argues that the Decision is correct because the audit evidence showed management's estimates were not consistent with market price declines in the latter half of 2008. But the Decision's conclusions stem from a failure to consider GAAP and relevant guidance.

The Decision assumes that if market prices decline, then so too should management's valuation estimates, and that any difference indicates management's estimates were inconsistent with market information. ID at 31. Thus, according to the Division and Decision, appraisals from the first part of 2008 should have been further discounted to reflect late-2008 market price declines. But this conclusion would require the Commission to ignore the accounting standards and even guidance on FAS 157 jointly issued by the SEC Office of Chief Accountant ("OCA") and Financial Accounting Standards Board ("FASB") in September 2008.

Market price declines are not recognized as declines in fair value where they are the result of forced transactions. This is clearly set forth in the OCA/FASB guidance. (J.P.F. ¶¶ 58-

60.) Remarkably, the Division fails to even *mention* this OCA/FASB guidance in its opposition brief, despite its own expert's admissions that FAS 157 was a crucial accounting issue in 2008 and "auditors and others were struggling with how to apply [FAS] 157 in markets where you had deteriorating conditions." (J.P.F. ¶ 480.) And management expressly noted its concern that market prices in late 2008 reflected foreclosure pricing.[3]

From the viewpoint of Mr. Aesoph and his team, therefore, management's voiced concern regarding extensive foreclosures in markets such as Nevada was reasonable and conformed with FAS 157 and OCA/FASB guidance.

B. The Characterization of FAS 157 as an "Undocumented Procedure" Illustrates the Decision's and Division's Refusal to Recognize FAS 157 as an Applicable Accounting Standard

The Division, like the Decision, uses the audit documentation standard to disregard FAS 157 because the auditors did not use the words "FAS 157" in the impaired loan work papers. *See* Opp'n Br. at 23. But FAS 157 is not a separate "procedure," a balance sheet account, or a financial statement assertion to which a certain "procedure" would apply. Rather, it is an accounting principle applicable to any account involving fair value estimates, including FAS 114. The fact that the auditors used the term "fair value" instead of "FAS 157" in the loan work papers is unremarkable, as everyone concedes "fair value" and "FAS 157" mean the same thing. The auditors' choice of words cannot be used to exclude from consideration a clearly-applicable accounting principle.

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[3] *See, e.g.*, Resp'ts Ex. 8 at KPMGTO5458 ("The Bank believes current 'non-liquidation appraisals' are more indicative of liquidation appraisals because they are based on a limited number of sales many of which are sales of foreclosed property.").

1. FAS 157 Principles Permeated the Auditors' Work Over FAS 114 Loans

The auditors viewed and assessed all FAS 114 procedures and related audit evidence with FAS 157's definition of fair value in mind. In Mr. Aesoph's words, the definition of fair value and its exclusion of distressed sales were "baked into our thinking" as auditors. (Tr. 1778:22-1779:7.) Indeed, at the time of the 2008 TierOne audit, FAS 157 was at the forefront of the entire accounting and auditing industry given its very recent adoption and its implications for collateral valuation in a deteriorating market. In response to growing concerns over the application of this accounting standard in the wake of the financial crisis, the OCA and FASB jointly issued additional guidance in September 2008—mere months before the auditors began year-end work—indicating foreclosure prices are not determinative of fair value. (J.P.F. ¶¶ 58-60.)

The uncontroverted evidence in the record shows the auditors applied FAS 157 to FAS 114 loans in their audit work. The auditors reviewed TierOne's financial statements' extensive disclosure addressing TierOne's application of FAS 157 to FAS 114 loans and provided detailed comments. (J.P.F. ¶¶ 119, 230.) The auditors' procedures included tying TierOne's FAS 157 disclosures to TierOne's impaired loans. (J.P.F. ¶ 230.) Mr. Aesoph discussed the application of FAS 157 with the Bank's Audit Committee, as reflected in a KPMG PowerPoint presentation retained in the work papers. (J.P.F. ¶ 119.) The work papers also indicate TierOne management represented to the auditors in writing that management understood the implications of its use of Level 3 inputs under FAS 157. (*Id.*)

Given the prominence of FAS 157 at the time of the audit and the auditors' review of the FAS 157 disclosures in TierOne's 2008 10-K, the Division's suggestion that the auditors were either ignorant of FAS 157 or otherwise failed to apply it falls flat.

2. Neither the Investigative Testimony nor the Wells Submission Detracts From the Applicability of FAS 157

Throughout their investigative testimony, Messrs. Aesoph and Bennett fairly and fully responded to each of the Staff's questions. The Staff never once referred to or asked about the auditors' considerations under "FAS 157." As in their work papers, Messrs. Aesoph and Bennett referred to "fair value"-—during their investigative testimony (more than 125 and 200 times, respectively) and in their Wells Submission—as a shorthand phrase for FAS 157. (J.P.F. ¶ 61 n.106; Tr. 1771:8-20.) As even the Division's own audit expert recognized, the phrase "fair value" is synonymous with FAS 157. (Tr. 2242:15-2243:11.) This makes it wholly unremarkable that Respondents would refer to "fair value" as opposed to formal accounting standard "FAS 157" when discussing fair value accounting for FAS 114 loans. (*See* Tr. 1778:22-1779:7 (Aesoph).) The Staff's apparent failure to grasp the standard's applicability during the investigation, despite its disclosure in TierOne's 2008 10-K and the prominence of fair value accounting as an issue at the time of the audit should not be held against Respondents.

Likewise, Messrs. Aesoph's and Bennett's investigative testimony that "the best . . . evidence of fair value of collateral is an appraisal" (*E.g.*, Tr. 370:16-19 (Bennett)), is entirely consistent with FAS 157. Appraisals generally provide the best evidence for evaluating the fair value of a piece of collateral at a particular point in time. Indeed, the auditors relied on the 2008 appraisals as audit evidence. The crux of this case, however, is whether some adjustment should have been made to the appraised values at year-end. As noted above, that was the auditors' focus in the audit. They concluded management's judgment that no adjustment was appropriate given the foreclosure contagion was entirely supported by the evidence, as interpreted through the lens of the applicable accounting principle: FAS 157. Further, the auditors assessed and found the total accrued 2008 losses "not inconsistent with" observable market conditions during the year as provided by AU § 328.

C. The Division's Creative Interpretation of FAS 157 Directly Conflicts With OCA/FASB Guidance and Its Own Audit Expert's Testimony

Not only does the Division completely ignore the relevant guidance on fair value measurements, it also offers a novel interpretation of FAS 157 supported only by its non-accountant economic expert and expressly disputed by every auditor who testified at the hearing. Opp'n Br. at 27; (J.P.F. ¶ 509.). The Division's proffered interpretation of FAS 157—that fair value is measured through a hypothetical transaction that assumes exposure to market forces—renders entirely meaningless the fair value definition in the standard itself, as well as the September 2008 OCA/FASB guidance on fair value measurements released precisely "to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment." (Resp'ts Ex. 66.) This guidance specifically directs, when evidence of fair value encompasses distressed transactions or forced liquidation sales (which, by definition, includes third-party market information and current appraisals reflecting distressed market prices resulting from foreclosures), such evidence does not reflect orderly transactions and thus is not determinative of fair value. (*Id.*)

The Division's novel proposed interpretation of FAS 157 is so contrary to the standard and OCA/FASB definition of fair value that even the Division's own audit expert, John Barron, could not support it. He testified that, in determining fair value under GAAP, one would exclude forced transactions. (J.P.F. ¶ 478.) He also testified that "it's generally understood that forced sales or liquidation sales or distressed sales really should be excluded in trying to determine comparable sales for the determination of fair market value. I mean, this is nothing new." (*Id.*) The Division fails to mention any of this record evidence.

Instead, the Division urges that the *Commission* is free to interpret the accounting and auditing standards, without regard to expert testimony. *See* Opp'n Br. at 16-17. First, the Division points to no legal authority stating the same discretion applies to an ALJ. Rather, as explained in Mr. Aesoph's Opening Brief, an ALJ must consider and weigh the whole record, including the expert testimony, and must demonstrate the basis of its ruling on each finding, conclusion, or exception presented. 5 U.S.C. § 556(d). The Decision in this case fails to state its basis for disregarding not just the testimony presented by Respondents and their audit expert, but *also* the testimony offered by the Division's audit expert regarding the appropriate measurement of fair value. Second, even were the Commission within its authority to interpret professional standards, it cannot do so in a way that deprives respondents of notice of the standards by which their previous conduct would be judged. *See Marrie v. SEC*, 374 F.3d 1196, 1206 (D.C. Cir. 2004). The Division's urged interpretation would result in precisely this deprivation of due process; Mr. Aesoph will have been deprived of the opportunity to know precisely what the Commission meant when he audited the 2008 financial statements for compliance with GAAP. And when the evidence is viewed through the lens of the plain meaning of the applicable standards, no finding of improper professional conduct can be supported.

III. The Decision's Brief Reference to Expert Testimony Does Not Constitute Appropriate Consideration and Weighing of That Testimony

The Division attempts to defend the Decision's failure to weigh expert testimony by misstating Mr. Aesoph's argument, by shrugging off the purpose and importance of expert testimony in an auditing case (and, in so doing, misstating relevant case law), and by vastly overstating the Decision's treatment of expert testimony. The Commission should reject the Division's misleading defense of the Decision's inadequate analysis.

A. The Division Misstates Mr. Aesoph's Argument and Mischaracterizes the Record

The Division's argument begins with a misstatement: that Mr. Aesoph believes Respondents' accounting expert, Sandra Johnigan, "is never discussed – ***not once***" in the Decision. Opp'n Br. at 16 (quoting Aesoph Opening Br. at 24) (emphasis by Division). In fact, Mr. Aesoph recognized that the Decision acknowledges Ms. Johnigan's testimony, noting that the Decision's entire discussion of all four experts' testimony comprises less than one page. Aesoph Opening Br. at 24. Mr. Aesoph's criticism stands—the Decision inappropriately gives the expert testimony only cursory treatment and fails to (1) "make any factual findings or conclusions"; (2) "make any credibility determinations"; (3) "explain [the Decision's] reliance, or [] decision not to rely, on any particular expert"; (4) "resolve [a] discrepancy in the Division's own witness testimony"; and (5) "consider and weigh the expert testimony." *Id.* at 24-26.

The Division's explanation of the Decision's findings regarding Ms. Johnigan (226 words) is more than twice as long as the Decision's actual treatment of her testimony (94 words). Neither treatment is adequate. Both Ms. Johnigan and the Division's audit expert, Mr. Barron, disagreed first on the relevance of FAS 157 to the 2008 audit and then as to whether the engagement team properly applied it.[4] (J.P.F. ¶¶ 376, 479-481.) The Decision does not address this distinction or determine which is more credible. Similarly, both Ms. Johnigan and Mr. Barron had available to them loan documentation that the auditors reviewed to support their conclusions on the audit.[5] Ms. Johnigan's conclusions were drawn from her review of these files

[4] Indeed, Mr. Barron was shown to have selectively quoted FAS 157 in his report and to have omitted the key provisions applicable to this matter. (J.P.F. ¶ 479.)

[5] Mr. Barron, however, did not have access to loan files, and thought it unnecessary to ask for them despite admitting they could impact his judgment regarding the 2008 audit. (J.P.F. ¶ 483.)

(Aesoph Opening Br. at 25), while Mr. Barron was forced to admit he did not review any of them and some of the opinions contained in his report were, therefore, wrong. (J.P.F. ¶¶ 483-84.) Yet the Decision does not address either expert's credibility. The Division makes no effort to justify these lapses.

B. Mr. Aesoph Is Entitled to Full Consideration of the Evidence

Case law demonstrates why the Decision's failure to consider and weigh expert testimony constitutes a critical lapse compelling reversal. The Division cites two previous accounting cases to support its proposition that the Decision need not "contain a lengthy dissertation on any party's expert witness."[6] Neither of these cases, however, addresses the level of expertise an ALJ may bring to accounting questions; both cases discuss the Commission's level of applicable expertise. Indeed, although the Commission affirmed the ALJ's findings in *McNeeley*, it explicitly weighed the respective experts' testimony and found the Division's expert "more persuasive."[7] In *Dearlove*, the Commission held the absence of a Division expert to testify on an accounting standard did not prevent the Commission from reaching conclusions about that standard, as its application was "straightforward, and well within [the Commission's] expertise."[8] The efforts in these cases to review and explain the standards upon which respondent accountants were judged—and weigh the evidence compelling the Commission's conclusions—are wholly absent from the Decision in this matter.

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6 Opp'n Br. at 16-17 (citing *McNeeley*, Exchange Act Release No. 61162, 2012 WL 6457291, at *18 (Dec. 13, 2012); *Dearlove*, Exchange Act Release No. 57244, 2008 WL 281105 (Jan. 31, 2008)).

7 2012 WL 6457291, at *17 ("We find, however, that the Division's experts' testimony and conclusion that McNeeley's conduct was 'an extreme departure from GAAS' was more persuasive.").

8 2008 WL 281105, at *20 n.75.

Previous Commission decisions further support this need to consider and weigh the evidence. In *Ernst & Ernst*, for example, the respondent accountants assembled as expert witnesses "an impressive array of leaders of the profession."[9] Although it ultimately agreed with the conclusions of the ALJ who authored the initial decision, the Commission held that the ALJ "did not give respondents' expert testimony the weight it deserved" and proceeded to weigh the experts' testimony throughout the balance of its opinion.[10] Notably, the Commission cited the same language the Division uses here—that expert opinions "may be helpful" but the Commission must "weigh" these opinions against its own judgment[11]—and still found it necessary to fully and explicitly consider those opinions. At best, the Decision deprives Mr. Aesoph of an explanation for how it weighs Ms. Johnigan's and Mr. Barron's credibility and conclusions. At worst, Mr. Aesoph is left to conclude the Decision does not consider these factors at all.

The Division would have the Commission defer to the Decision's unspoken and/or nonexistent weighing of expert testimony by arguing that ALJs are themselves experts and need not include in an initial decision a "lengthy dissertation on any party's expert." Opp'n Br. at 17. Perhaps this is true. But GAAP—at issue in this case—"is not [a] lucid or encyclopedic set of pre-existing rules . . . . GAAP changes and, even at any one point, is often indeterminate." *Shalala v. Geurnsey Mem. Hosp.*, 514 U.S. 87, 101 (1995). To uphold this element of the Decision is to say that ALJs have such a high degree of competence in auditing standards and accounting standards as complicated as FAS 157—which the Commission itself saw fit to clarify

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[9] SEC Accounting Series Release No. 248, 1978 WL 207542 (May 31, 1978) (citing *United States v. Simon*, 425 F.2d 796, 805 (2d Cir. 1969)).

[10] *Id.*

[11] *Compare id.*, *with* Opp'n Br. at 16.

in 2008 (J.P.F. ¶¶ 58-60)---that an initial decision need not consider or explain its determinations on expert audit testimony at all. The Commission should correct this error and reject the Division's attempt to defend it.

IV. The Division Wrongfully Ignores or Mischaracterizes Evidence in Defending the Fatally-Flawed Decision

A. The Division's Attempt to Minimize the Auditors' Loan File Reviews Contradicts the Evidence

The Division persists in calling the auditors' loan file reviews "undocumented" despite all evidence to the contrary. First, the Division does not deny that the work papers document approximately 200 instances in which the engagement team obtained and reviewed materials from TierOne's loan files. (J.P.F. ¶ 451.) As demonstrated at the hearing, the loan files contained information such as appraisals, loan analyses, and credit reviews relevant to many aspects of the audit. (J.P.F. ¶¶ 340, 344-46.) The Division downplays these documented reviews by suggesting that "nearly all" of those instances related to internal control testwork unrelated to FAS 114 collateral values. Opp'n Br. at 29 n.8. But audit procedures are not performed in a vacuum, and familiarity gained with a loan and loan file in one procedure informs an auditor's understanding when reviewing that same loan as part of a different procedure. (*E.g.*, J.P.F. ¶¶ 351-52.)

More significantly, the auditors *did* consult loan files as part of their substantive procedures over the FAS 114 loans and made notations reflecting that corroborating evidence on the face of many of the FAS 114 templates. (J.P.F. ¶¶ 335-37.) This was the uncontroverted testimony at the hearing. As Mr. Bennett explained, the tick-marks and notations on the FAS 114 templates meant "we had our hand on the document. We were evaluating management's assumptions. In instances where we were looking at appraisals, it was common practice for management just to bring in . . . the full loan file, because it contained the appraisals." (J.P.F.

¶ 341 (Tr. 694:21-696:23).) The Division's belief that Respondents "fail to explain how those [FAS 114] templates show a review of loan files" (Opp'n Br. at 29 n.8), results from an apparent unwillingness to accept work paper notations stating "agreed to appraisal" rather than "agreed to appraisal located in the loan file."

Indeed, the Division's position seems rooted in its audit expert's written report, where Mr. Barron opined that the auditors had failed to corroborate assumptions on the FAS 114 templates. But on cross-examination, Mr. Barron admitted he was wrong. He testified that references stating "agreed to appraisal" meant the auditors had in fact looked at the appraisal, and he admitted that appraisals were located in the loan files. (Tr. 1312:13-19, 1327:19-1328:2.) He testified that other information on the FAS 114 templates was similarly corroborated with information in the loan files, including, for example, that despite the conclusion in his written report to the contrary, the auditors had obtained loan file documentation that corroborated assumptions in the FAS 114 templates. (J.P.F. ¶¶ 343, 484.) Mr. Barron further stated he "would not expect [the auditors] to take an entire loan file and save it in their work papers." (Tr. 1330:2-6.) In light of this record evidence, the Decision's and Division's attempts to characterize the loan file reviews as undocumented and immaterial ring hollow.

The Division's failure to contend with its expert's admissions only underscores the fundamental nature of the Decision's failure to do the same. While the Division might be excused from mentioning evidence contrary to its theories of the case in the interest of advocacy, the Decision cannot escape its obligation to weigh the evidence. An ALJ must not only mention this evidence, but also must weigh it in the context of the full record. *See* Aesoph Opening Br. at 9-11. But the Decision here adopted nearly wholesale the Division's characterization of the record, without explaining whether it considered Respondents' evidence in the context of the full record. Without any such analysis or explanation, the Decision risks appearing a rubberstamp on the Division's urged interpretations and threatens the legitimacy of the entire process.

B. The Division Inaccurately Describes Respondents' Identification and Testing of Internal Controls

The Division's internal control analysis—adopted part and parcel in the Decision—simply ignores work paper documentation contrary to its position. As detailed in Mr. Aesoph's Opening Brief (pp. 29-33) and brief in opposition to the Division's opening brief (pp. 16-19), the Division's and Decision's descriptions of the internal controls that gave Mr. Aesoph comfort regarding management's control process over the risk of collateral overvaluation fall far short.

In its opposition brief, the Division tacitly acknowledges that at least one control—finance department review of the FAS 114 templates—did, in fact, address the risk of collateral overvaluation on impaired loans, but suggests it somehow does not count because the detailed description of this process appears in the "binder of materials management provided" to the auditors. Opp'n Br. at 37-38 & n.12. This work paper binder—Binder 2—contains Internal Audit documentation and was indeed provided by management, but it also contains signatures of all management attesting to the accuracy of the FAS 114 process as tested at LOT 12-2. (*See* Resp'ts Ex. 2A at KPMGTO3027, 3031-32.) As documented in the work papers, Mr. Aesoph's team independently tested LOT 12-2 (Resp'ts Ex. 7 at KPMGTO5030), and did so with knowledge of the Internal Audit work performed and documented in Binder 2. As part of its testwork regarding management review of the ALLL, the engagement team inspected documents and records and spoke to the controller, Mr. Kellogg, about this process. (*Id.* at KPMGTO5056; J.P.F. ¶ 278.)

Further, the engagement team documented its test of the Asset Classification Committee's ("ACC's") impaired loan review, which separately addressed the risk of collateral overvaluation. The Division incorrectly contends the ACC did not "review the FAS 114 templates or otherwise test the calculations or assumptions relating to the FAS 114 loans." Opp'n Br. at 38. Yet the uncontroverted evidence shows the auditors inspected the documents made available to the ACC, including detailed information on individual impaired loans and collateral. (Resp'ts Ex. 7 at KPMGTO5076; J.P.F. ¶¶ 285-98.) Moreover, as part of its control testwork, the auditors assessed the knowledge of Mr. Kellogg—an ACC member "intimately aware of the [FAS] 114 calculation" (J.P.F. ¶ 287 (quoting Respondents' audit expert))—who confirmed to the auditors that the ACC "discusses the recent trends, status changes within the portfolios, *reserve modifications, and FAS 114 impairments*." (J.P.F. ¶ 284 (quoting Resp'ts Ex. 7 at KPMGTO5076 (emphasis added)).)

Despite the Division's desire to wish these procedures away, the work papers show Mr. Aesoph and his team performed and documented sufficient testwork to give him a reasonable basis to conclude management's internal controls addressed the risk of collateral overvaluation. The Decision's failure even to address this internal control testwork provides yet another example of the absence of any full and fair weighing and evaluation of the record evidence.

C. Respondents Appropriately Assessed the Seriousness of the Office of Thrift Supervision ("OTS") Report and Modified Their Audit Plan Accordingly

In October 2008, the OTS released a Report of Examination ("Report") seriously criticizing TierOne, including in the areas of asset quality and management. The Division, over several pages of briefing, emphasizes the seriousness of this Report but largely disregards the second half of the story. The evidence shows Mr. Aesoph reviewed the Report and took a number of audit steps in response—all of which the Division's own audit expert acknowledged reflected the exercise of due professional care. (J.P.F. ¶ 491.)

In response to the Report, Mr. Aesoph:

- Directed Mr. Bennett to draft a work paper memorandum analyzing the Report and reflecting feedback from management and Internal Audit (J.P.F. ¶ 194);

- Engaged additional KPMG expertise to review the Report, including specialists from the regulatory services group, the SEC review partner, and the Professional Practice Partner for the region who was a prior SEC review partner on the TierOne engagement (J.P.F. ¶¶ 194, 198);

- Tracked management's responses to the Report and related Supervisory Agreement and documented in the work papers management's resolution of OTS comments as reflected in a regulatory tracking chart kept by Internal Audit (J.P.F. ¶¶ 201-02); and

- Consulted with the Mr. Pittman, the OTS Field Manager responsible for TierOne, in February 2009, to confirm his understanding that management was satisfactorily responding to OTS criticisms (J.P.F. ¶ 204).

The Division erroneously contends that Mr. Aesoph's references to KPMG's regulatory group and Mr. Pittman are an "attempt to downplay the significance of the OTS report." Opp'n Br. at 7 n.2. The reverse is true. As even the Decision recognizes, Messrs. Aesoph and Bennett "took the report seriously and were fully aware of its findings." ID at 12. Contrary to the Division's position, Mr. Aesoph's many actions taken to address the OTS's findings are evidence of the due professional care he showed in response to the Report.

The Division's own audit expert recognized as much. (J.P.F. ¶ 204.) Mr. Barron agreed each action taken by Mr. Aesoph—Mr. Bennett's memorandum, consulting with other KPMG professionals, tracking TierOne's remediation of OTS issues, and contacting Mr. Pittman—demonstrated due professional care. (J.P.F. ¶ 491.) Moreover, the Division's recitation of OTS criticisms ignores the favorable findings the OTS made in the same Report, including that the ALLL was appropriately stated at June 30, 2008; that management had recently hired experienced personnel to help handle the troubled loan portfolio; and that management had "developed an appropriate [FAS 114] template in 2008 to measure quarterly impairment loss on impaired loans pursuant to SFAS No. 114." (J.P.F. ¶¶ 197, 212.) It also ignores Mr. Pittman's testimony that he told Respondents at the time of the audit that management was appropriately addressing the concerns raised by the OTS. (J.P.F. ¶ 206.) In short, Mr. Aesoph's treatment of the Report, far from demonstrating professional negligence, illustrates the due professional care he showed throughout the audit.

D. The Division Offers No Support for Its Erroneous Interpretation of AU § 561 and Ignores Important Facts Surrounding the Receipt of New Appraisals in 2009

The Division's interpretation of AU § 561 is unsupported by precedent or evidence. While the standard requires additional procedures if the auditor "becomes aware that [1] facts may have existed at [the date of the auditor's report] which [2] might have affected the report had he or she then been aware of such facts" (AU § 561.01), the Division's interpretation of the second part of that test would render the standard meaningless. AU § 561 is only triggered if the subsequently-discovered facts "might have affected the report"—that is, resulted in restatement of the financial statements. This measure is objective and observable; any lower threshold would render the "might have affected" language too vague and subjective to provide any real guidance to auditors. Respondents' audit expert, Ms. Johnigan—a member of the Auditing Standards Board—made this clear in her report: "'Affect the report' means that the auditors in 1Q 2009 would have concluded that the 2008 financial statements not reflecting such information were materially misstated." (Resp'ts Ex. 42 at 80.) The Division offers no support for its alternative interpretation of the standard.

The Division's discussion of the new appraisals received in early 2009 omits key facts that show precisely why those new appraisals failed to trigger AU § 561. The Division refers to two new appraisals showing declines from year-end values, but neglects to mention a third new appraisal reflecting a $1.5 million *increase* in collateral value compared to the year-end estimate (which only underscores the challenge of estimating fair value in this volatile market), and the

Decision essentially adopts this characterization. (J.P.F. ¶ 419.) As Ms. Johnigan explained, this third appraisal was significant because it indicated a lack of bias and lowered the net effect of these new appraisals on loan loss reserves: the new appraisals represented approximately $4 million in additional losses, while 2008 financial statements reflected a $93 million pretax loss and an $84 million loan loss reserve. (J.P.F. ¶¶ 423-25.) Also, these additional loss figures were not inconsistent with previously-recorded losses on these loans in 2008. (J.P.F. ¶¶ 421-22.) For example, the auditors observed that as to one challenged loan, management decreased its fair value estimate by 25% in the first quarter, then by 45%, 50%, and 55% in the following quarters. (J.P.F. ¶ 421.) The two new appraisals the Division highlights in fact reflected a continuation of the discount approach management applied throughout 2008. (J.P.F. ¶ 422.) In short, these new appraisals did not reflect new information material to TierOne's 2008 financial statements taken as a whole and the Decision fails to explain its contrary conclusion.

V. Rule 102(e) Sanctions Against Mr. Aesoph Are Inappropriate

As discussed in Mr. Aesoph's Opening Brief, the sanction against him is arbitrary and capricious. As even the Decision recognizes, this is a case involving difficult professional judgments in the face of an unprecedented economic climate, evolving Commission guidance regarding the requirements of FAS 157, and pervasive management fraud. In such circumstances, a Rule 102(e) proceeding is unwarranted, and the Commission should reverse the sanction.

A. Rule 102(e) Cannot Be Used to Perform Hindsight Analysis of Difficult Professional Judgments

Rule 102(e) is "not intended to cover all forms of professional misconduct," including "acts of 'simple negligence' [or] errors in judgment." 63 Fed. Reg. 57,165-68 (Oct. 26, 1998). Rather, it addresses only "that category of professional conduct that threatens harm to the

Commission's processes." *Id.* at 57,165. Even "[a] single judgment error . . . [and] even if unreasonable when made, may not indicate a lack of competence to practice before the Commission." *Id.* at 57,166. Difficult judgment calls are entirely outside its scope. *See id.* Mr. Aesoph's judgments in recognizing risk, increasing procedures to address risk, and evaluating accounting estimates in the uncertain economic and regulatory environment of the time are explicitly excluded from the types of conduct Rule 102(e) proceedings are intended to address.

It is only through hindsight that the Division questions Mr. Aesoph's judgments. The Division argues that Respondents demonstrate a lack of appreciation for an auditor's core responsibilities by arguing "there was nothing more [they] could have done." Opp'n Br. at 43. Setting aside this mischaracterization, the appropriate question is not what an auditor "could have done." Rule 102(e)'s heightened negligence standards prohibit the Commission from "evaluat[ing] actions or judgments in the stark light of hindsight," and ask instead, what "actions a reasonable accountant should have taken if faced with the same situation." 63 Fed. Reg. 57,168. Only through hindsight can the Division argue Mr. Aesoph "could have done" more to assess impaired loan valuations. And only through hindsight can the Division discuss a Q3 2009 $120 million charge to insinuate audit deficiencies in 2008 (Opp'n Br. at 11),[12] but neglect to mention this $120 million charge led to Mr. Aesoph relentlessly pursuing the truth surrounding management's fraud (Aesoph Opening Br. at 43).

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[12] The relevance of the $120 million charge to the 2008 audit is belied by the Division's own economic expert, who estimated an additional $20 million in impaired loan losses at year-end, based solely on an estimate of market price declines and not declines in fair value. (Div.'s Ex. 191 at 64-65, 106; J.P.F. ¶¶ 512-13.)

B. Rule 102(e) Requires the Commission to Review the Audit as a Whole and in Context

The Commission should reject the Division's attempt to use hindsight to mischaracterize the audit record and stretch a single course of events to fit the purposes of a Rule 102(e) proceeding. The Division argues that Mr. Aesoph "suggests he should not be held liable [because his] only misconduct involved the FAS 114 portion of the ALLL." Opp'n Br. at 43. To the contrary, Mr. Aesoph argues that he employed a single approach—informed by FAS 157—to evaluate a single component of a single account during a single audit, and that this cannot form the basis of a charge that he engaged in "repeated instances" of unreasonable conduct. Aesoph Opening Br. at 44; 63 Fed. Reg. 57,164, 57,169. The Division and Decision treat this course of conduct as separate instances, seeking to distract the Commission from the context of the audit.

The Division does not contest that, aside from the FAS 114 portion of the ALLL account, the audit was conducted in compliance with professional standards. This would not excuse a failure to properly audit impaired loans, but it does raise the question why Mr. Aesoph—who incontrovertibly conducted the bulk of the audit in compliance with professional standards, recognized the risks posed by the ALLL account, and increased procedures to address that account—would neglect his professional duties with respect to impaired loan valuation. The answer lies in Mr. Aesoph's judgment of the appropriate determination of fair value as understood through FAS 157 and the Commission's expectations of accounts audited using FAS 157. Mr. Aesoph's judgment regarding this single account cannot be used to describe him as a threat to the Commission's processes. The Commission should reject the Decision's findings and the Division's argument suggesting otherwise.

VI. CONCLUSION

In conducting the year-end 2008 audit, Mr. Aesoph did exactly what was required of him under FAS 114, FAS 157, and OCA/FASB guidance. When the record is viewed in the context of these applicable accounting and auditing guidelines, it becomes clear that the audit team's conclusions were reasonable, and this case instead boils down to the sufficiency of audit documentation. While Mr. Aesoph agreed that, in hindsight, he would have documented certain of his considerations in more detail, nothing about the documentation rendered his conduct unreasonable or highly unreasonable under Rule 102(e). Never before has the Commission stripped an auditor of his career over the degree to which a particular consideration was documented, and the Commission should not do so now.[13]

Rule 450(d) Certification: Undersigned counsel certifies that this brief contains 6,986 words and therefore complies with the limitations set forth in Rule of Practice 450(c).

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Respectfully submitted,

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[13] Consistent with 15 U.S.C. § 78y and relevant case law, Mr. Aesoph reserves for judicial review arguments otherwise challenging the constitutionality of these proceedings where the Commission lacks the power or jurisdiction to decide such challenges or where it would otherwise be unreasonable to raise such issues before the Commission, including where such arguments challenge the very composition or constitution of the agency.