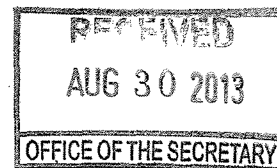

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15168

In the Matter of	:	
	:	**DIVISION OF ENFORCEMENT'S**
JOHN J. AESOPH, CPA, and	:	**PREHEARING BRIEF**
DARREN M. BENNETT, CPA	:	
	:	
	:	

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I. PRELIMINARY STATEMENT

Independent auditors play a critical gatekeeping role. They are appropriately charged with acting with due care and appropriate skepticism, particularly in areas of heightened risk. Respondents John J. Aesoph and Darren M. Bennett, the partner and senior manager, respectively, on the 2008 audit of TierOne Corporation and TierOne Bank ("TierOne"), violated these basic professional standards. They did so by failing to subject one of the riskiest areas of the audit – loan loss estimates on some of the bank's most troubled loans – to any significant scrutiny. As a result, respondents engaged in improper professional conduct.

The account at the core of this case is TierOne's Allowance for Loan and Lease Losses ("ALLL"), which is a reserve account intended to cover losses in a bank's loan portfolio. The ALLL consists of two elements: losses related to large, troubled loans accounted for under Statement of Financial Accounting Standards No. 114 ("FAS 114"), and losses related to pools of smaller loans accounted for under Statement of Financial Accounting Standards No. 5 ("FAS 5"). This case involves respondents' deficient audit of the first element of the ALLL account, the FAS 114 loans.

By the end of 2008, TierOne's ALLL was one of the most, if not the most, critical audit areas. In the years prior, TierOne had loaned tens of millions of dollars for large land development and construction projects in then-booming areas of the United States, such as Las Vegas. At the time of the 2008 audit, many of these loans were in serious trouble. As a result of the global financial meltdown, these areas were experiencing plummeting real estate values, and thus the value of the collateral securing the loans (*i.e.*, the underlying land or construction project) was rapidly deteriorating. TierOne calculated losses on these large, troubled loans under FAS 114.

A key component to estimating these FAS 114 losses was the value of the loan's underlying collateral: generally speaking, if collateral value fell below loan book value, losses were to be recognized. And those losses could be very significant to the bank. At the end of 2008, TierOne was just over its regulatory capital requirements, and additional losses would push the bank closer to breaching these critical benchmarks, potentially inviting serious enforcement actions.

The plummeting markets and tightening margins were not the only red flags related to the ALLL account, and the FAS 114 loans in particular, that Aesoph and Bennett encountered. Just months before the 2008 audit began, TierOne's federal regulators had issued a scathing report that focused much of its criticism on the bank's "inept" loan administration practices, called out troubles in the bank's loan portfolio, and found a significant understatement of the ALLL. In addition, TierOne received several new appraisals early in 2008 indicating it had overvalued collateral on its FAS 114 loans. Nonetheless, it essentially stopped updating appraisals in the second half of the year, even as market declines accelerated. Thus, at the time of respondents' 2008 audit, TierOne often valued the collateral for, and thus calculated the losses on, its FAS 114 loans using stale appraisals that did not account for the significant real estate market declines.

Respondents claim to have recognized the risks related to the ALLL, rating the account one of the riskiest in the audit. Audit standards require that this risk assessment drive audit procedures: greater risk requires more extensive procedures and more reliable evidence. But despite the risk, and the significant red flags surrounding the ALLL, respondents performed perfunctory procedures over the FAS 114 loan loss estimates. Essentially, they were comfortable with management's representations that collateral values based on stale appraisals were reasonable, even though the estimates were often inconsistent with independent market data

showing collapsing real estate values. Respondents gathered little if any evidence to corroborate these representations or otherwise test the estimates. These failings were compounded by the deficient work in auditing TierOne's internal control over financial reporting: the auditors failed to identify or test a control addressing the key risk point that collateral may be overvalued on FAS 114 loans.

In the months after the audit, and as a result of the federal regulator's regularly-scheduled examination in mid-2009, TierOne updated its appraisals and disclosed tens of millions of dollars in additional loan losses. These losses ultimately led to the bank's failure.

Respondents' cursory audit over a critically risky area violated basic tenets of independent auditing and applicable professional standards. This constitutes negligent conduct under Rule 102(e) of the Commission's Rules of Practice, including both a single instance of highly unreasonable conduct in circumstances requiring heightened scrutiny and repeated instances of unreasonable conduct that indicate a lack of competence to practice before the Commission.

II. RESPONDENTS AND RELATED PARTIES

A. Respondents

John J. Aesoph, CPA, age 41, is a resident of Omaha, Nebraska. Mr. Aesoph has been an auditor at KPMG since 2001, and a partner at the firm since 2005. He was on the TierOne audit engagement from 2002 through KPMG's resignation in 2010, and was the engagement partner for the 2008 audit. Mr. Aesoph is currently licensed as a CPA in Nebraska and South Dakota, and has previously been licensed as a CPA in Idaho, Indiana, Iowa, Kansas, and North Dakota. As the engagement partner, Mr. Aesoph had the final responsibility for the conduct of

the audit, was responsible for all significant decisions made in the course of the engagement, and was responsible for ensuring that the audit complied with professional standards.

Darren M. Bennett, CPA, age 36, is a resident of Elkhorn, Nebraska. Mr. Bennett has been an auditor at KPMG since 2001. He worked on the TierOne audit each year from 2003 through KPMG's resignation in 2010, with the exception of one year. Mr. Bennett was the senior manager for the 2008 TierOne audit. Mr. Bennett is licensed as a CPA in Nebraska, North Dakota, and South Dakota. As the senior manager, Mr. Bennett was responsible, in consultation with and under the supervision of the engagement partner, for determining the audit procedures applicable to specific audit areas, for maintaining uniform standards of fieldwork, and for complying with professional standards.

B. Related Parties

TierOne Corporation, a Wisconsin corporation, was, during the relevant time period, a holding company for **TierOne Bank**, a federally-chartered savings bank headquartered in Lincoln, Nebraska. On June 4, 2010, TierOne Bank was closed by its primary regulator, the United States Office of Thrift Supervision ("OTS"). The Federal Deposit Insurance Corporation ("FDIC") was named receiver and another bank took over TierOne's assets and deposit accounts. TierOne subsequently filed for Chapter 7 bankruptcy protection on June 24, 2010.

KPMG LLP is a limited liability partnership headquartered in New York, New York, engaged in the business of providing accounting and auditing services. KPMG audited TierOne's 2008 financial statements and internal control over financial reporting as of December 31, 2008 and issued unqualified opinions.

III. FACTS

A. Background on the ALLL and FAS 114 Loan Portfolio

The ALLL is a critically important account at any bank. Essentially, the ALLL is a reserve account intended to cover "known and inherent" losses in a bank's loan portfolio. As noted briefly above, the ALLL consists of two elements. The first is a reserve related to individual loans that are deemed "impaired" – meaning a bank considers it probable it will not collect all amounts due under the terms of the loan – pursuant to FAS 114. TierOne's FAS 114 loans were typically large-dollar loans made to fund land development or construction projects, often in areas of the country where, by the end of 2008, real estate declines were most pronounced. The second element of the ALLL is a reserve for losses on categories of loans, which, pursuant to FAS 5, are grouped together by type and level of risk, and then a general "loss factor" is applied to each group. At TierOne, these were often smaller loans for consumer purchases, automobiles, or residences. This case involves the first – and, at TierOne, the riskier – element of the ALLL.

TierOne typically measured losses on its FAS 114 loans by evaluating the estimated value of the collateral underlying each individual loan, which was done by referencing the most recent appraisal. In general, the loss was calculated by comparing the book value of the loan to the collateral value, which is the fair value of the collateral adjusted for the time and cost to sell the collateral. A loss was recorded if the collateral value fell below the loan book value. Importantly, the estimate of collateral value must be made at the specific point in time that losses are being measured. That is, TierOne was required to estimate what the underlying collateral was worth as of December 31, 2008, the date of the financial statements that Aesoph and Bennett audited. In short, a critical element to properly estimating losses on TierOne's FAS 114 loans

was the fair value of the underlying collateral at December 31, 2008. Generally speaking, overestimating that collateral value would result in underestimating loan losses.

At the time of the audit, TierOne had evaluated more than $200 million of its loans for impairment under FAS 114. This represented approximately 180 loans made to a total of about 50 different borrowers. Most were large land development, residential construction, or commercial construction loans. Many of the loans were in markets that had seen the most dramatic declines in real estate values. Nevada had by far the highest concentration by loan value, accounting for more than half of all loans evaluated under FAS 114. The remaining loans were spread across eight states: Arizona, Florida, Minnesota, North Carolina, South Carolina, Colorado, Nebraska, and Texas. Again by loan value, besides Nevada, no other state accounted for more than about 10% of the loans evaluated under FAS 114. Although TierOne prepared, and the auditors reviewed, FAS 114 analyses on each of the 50-plus borrower relationships, ten relationships were ultimately not deemed impaired. All told, TierOne classified $186 million in loans as impaired (and thus calculated losses on those loans under FAS 114) as of year-end 2008.

B. Context of the 2008 Audit

Throughout 2008, significant events occurred at the bank and in the broader economy that made clear that TierOne's ALLL, and the FAS 114 element specifically, deserved heightened scrutiny.

1. TierOne's Federal Regulators Condemned the Bank's Loan Practices

In mid-2008, TierOne's primary regulator, the OTS, conducted a regularly scheduled examination of the bank. In October 2008, shortly before the year-end audit began, the auditors received the examination's damning results. The OTS warned that "[t]he overall financial condition of the bank is unsatisfactory. Performance of the board of directors … and

management is deficient. The bank is in troubled condition." The OTS further concluded that management had "violated [its] fiduciary duty to exercise the highest standard of care in the conduct, management, and oversight of the bank's affairs."

The OTS took particular aim the bank's management of its loans and lending practices. It deemed the bank's credit administration practices "inept," and its credit risk management practices "particularly inadequate for the nature and complexities of the bank's activities." It found "[t]he level of problems and risk exposure is extreme" and that "[t]he ALLL and valuation allowances are inappropriate relative to portfolio risk." It specifically criticized the bank's practices regarding appraisals, finding that "[a]ppraisals of land and construction loans are inadequate and unsupported" resulting in violations of the federally-mandated minimum appraisal standards. The OTS concluded that these appraisal deficiencies, among others, were "unsafe and unsound practices" that were a "substantial violation" of federal guidelines. The OTS further found "loans with no appraisal[s], unsupported appraisals, and stale appraisals."

In diagnosing the cause of TierOne's problems, the OTS homed in on large, troubled loans in areas of the country with plummeting real estate values – precisely the type of loans that made up the bulk of TierOne's FAS 114 loan portfolio. For example, the OTS called out the bank's significant concentration of construction and land development loans in the Las Vegas area, and concluded that the bank's "large investment in loans secured by properties in markets experiencing marked declines in real estate values," which included Las Vegas, "exacerbated the [loan] losses."

In sum, the OTS concluded that

> [t]he bank's deteriorating financial condition is principally the result of poorly administered concentrations of higher risk credits in rapidly flagging national markets that, until recently, were hotbeds for lending activity. Management and the board failed to satisfactorily monitor, assess, and respond timely to the

> declining market conditions in the southwest Florida and Las Vegas real estate markets, and the adverse impact of these weakening markets on the quality of the bank's assets, the adequacy of its ALLL, and its capital.

As a result of its examination, the OTS downgraded the bank from a "1" on the so-called CAMELS rating scale, which indicated the bank was "sound in every respect," to a "4," the second-lowest rating and an indication that the bank "exhibit[s] unsafe and unsound practices or conditions," has problems "rang[ing] from severe to critically deficient," and has "weaknesses and problems [that] are not being satisfactorily addressed by the board of directors and management."

2. The OTS Identified a Significant Deficiency in TierOne's ALLL

On top of its criticisms, the OTS found management had underestimated the ALLL. The OTS report "identified a deficiency in ALLL and unreserved losses ranging between $17.0 million and $22.0 million, at March 31, 2008." This amount was significant: TierOne had previously recorded ALLL of $78 million as of March 31, 2008, meaning the OTS identified an understatement of approximately 25%. While TierOne addressed this understatement by recording additional loss provisions during the second quarter of 2008, the deficiency should have raised serious concerns about management's ability to properly estimate its loan losses.

3. The OTS Raised TierOne's Capital Requirements

Further, the OTS elevated TierOne's capital holding requirements. Failing to meet these requirements could have led to serious enforcement actions, including civil monetary penalties, the appointment of a receiver, or a forced merger into another lending institution. As TierOne itself acknowledged in its 2008 Form 10-K, such actions could have a "direct material adverse effect on our financial condition and results of operations." Of particular importance to this case,

loan losses had a direct impact on these capital requirements: additional losses would push the bank closer to falling below the elevated capital levels.

At the time of the 2008 audit, the bank teetered on the edge of these elevated capital requirements, even after receiving nearly $30 million in capital from TierOne Corporation during the year. The OTS required the bank to maintain an 8.5% ratio of "core" capital to assets, and 11.0% ratio of "risk-based" capital to assets. As of December 31, 2008, the bank's ratios stood at 8.9% and 11.6%, respectively – only $12-$15 million, and just tenths of a percent, above required levels.

The elevated capital requirements were significant not only because of the incentive they gave TierOne to understate loan losses in order to stay compliant, but also because of the way they were communicated to the auditors. Respondents recognized the importance of these elevated capital requirements: Mr. Bennett agreed, for example, that the increase represented a "significant event for the bank." Despite their importance, however, TierOne management did not tell respondents about the elevated capital requirements at the time they were imposed by the OTS, which was in early June 2008. Rather, respondents did not learn of the requirements until months later, when they received the OTS report in October 2008. When asked about his reaction to this belated disclosure, Mr. Aesoph voiced his frustration, stating that he clearly "was not pleased when this occurred."

4. Updated Appraisals Throughout 2008 Showed Management Bias

The OTS's actions were not the only red flag that TierOne may have been underestimating its loan losses. TierOne also received several updated appraisals in 2008 – mostly in the second quarter, and mostly on Nevada loans – that suggested management was biased in overestimating collateral values on FAS 114 loans. At the end of the first quarter of

2008, KPMG reviewed TierOne's FAS 114 analyses on eight lending relationships. By the end of the second quarter, TierOne had received updated appraisals on loans within five of those eight lending relationships. Many were dated in April 2008, just weeks after the first quarter closed. In almost all cases, the new appraisals showed a significant decline in the previously estimated collateral value.

For example, at the end of the first quarter, TierOne prepared a FAS 114 analysis for Storybook Homes, a large land loan in Las Vegas. In that analysis, TierOne discounted the eight-month old appraisal and took an additional reserve. Even with these adjustments, however, a new April 2008 appraisal showed a nearly 30% decline in the first quarter collateral estimate and resulted in more than $3.5 million in additional loan losses. While not all of these new appraisals resulted in additional loan losses, many did. All told, the new Nevada appraisals received during the second quarter required TierOne to record nearly $7 million in additional loan losses.

These updated appraisals should have been cause for concern for another reason: the fact that the updates essentially stopped after the second quarter. During the remainder of the year, TierOne obtained updated appraisals on only two more FAS 114 loans. Notably, despite the fact that these two loans were located in relatively "stable" markets – Nebraska and Colorado – the new appraisals showed a nearly 50% decline in the collateral value TierOne had used in the prior quarter, and led to more than $1 million in additional ALLL.

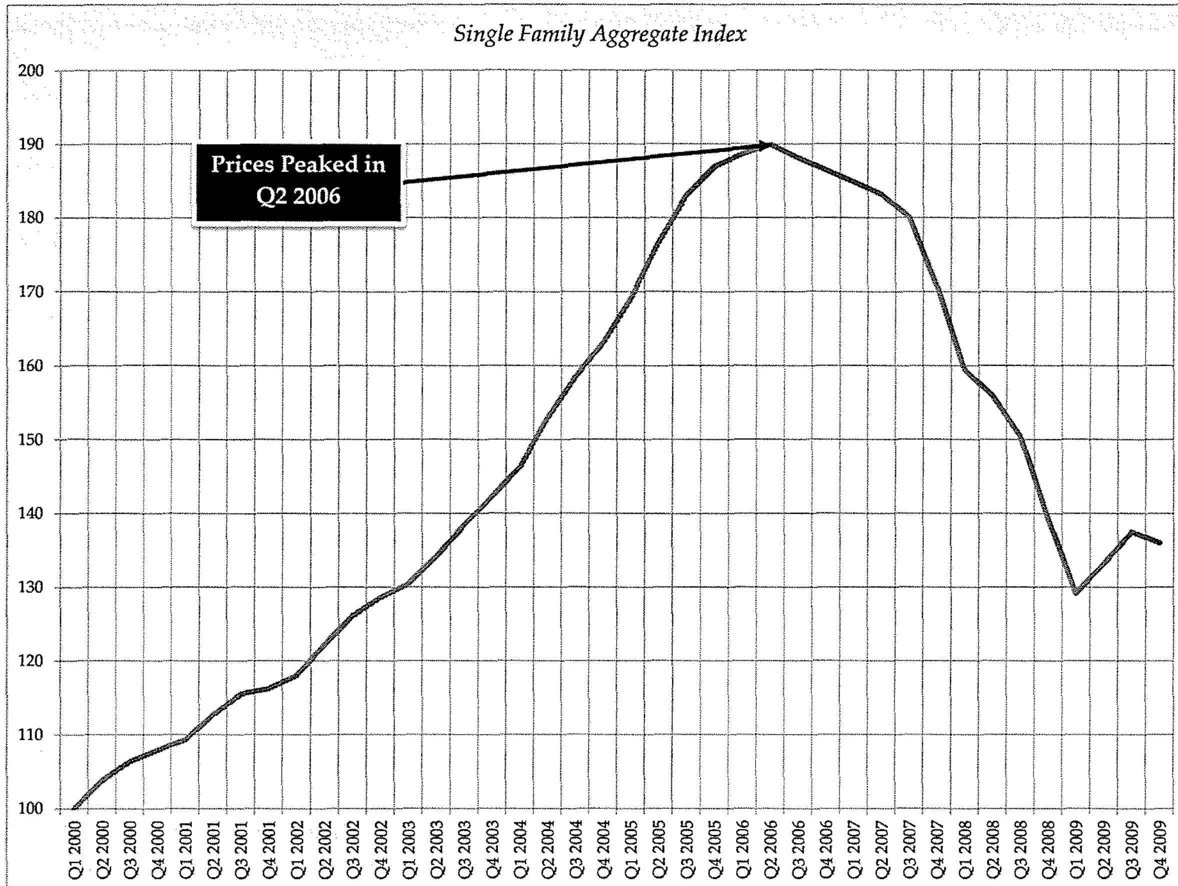
These significant drops in collateral value as a result of new appraisals, combined with the fact that TierOne basically stopped updating appraisals as 2008 went on, should have raised questions about management's estimates of losses on the bank's FAS 114 loans. Further, these red flags should have led Aesoph and Bennett to scrutinize whether additional loan losses were inherent in TierOne's FAS 114 loan portfolio at year end.

5. TierOne's Impaired Loan Portfolio Grew Throughout 2008

Although TierOne stopped updating appraisals on its FAS 114 loans, it did continue adding loans to its FAS 114 portfolio. As noted above, by the end of 2008, TierOne prepared, and the auditors reviewed, FAS 114 analyses on more than 50 lending relationships totaling well over $200 million in loans. The majority were located in particularly hard-hit markets: Nevada alone accounted for more than half of the lending relationships. As TierOne reported in its 2008 Form 10-K, the level of impaired loans had "increased significantly due to deterioration in the nation's economic conditions. The real estate market continued to decline in 2008 …."

6. Real Estate Values Plummeted Throughout 2008

TierOne's assessment of the markets was accurate, if incomplete. Not only did the real estate market continue to decline in 2008, that decline accelerated as the year went on. For example, as shown in the following chart, Case Shiller's national home price index showed a precipitous and increasing decline in values during 2008:



The decline was even worse for many of the markets where TierOne's FAS 114 loans were located. For example, in Nevada – home to the largest concentration of loans evaluated under FAS 114 – home prices declined more than 30% throughout 2008. As with prices nationally, the bulk of this decline came in the second half of the year: prices fell by approximately 10 percent in the third quarter and another 10 to 15 percent in the fourth quarter.

Significantly, most of the Nevada loans were related to condominium projects or land development, two types of real estate that had experienced even more pronounced declines than single family homes. Condominium prices in the Las Vegas area had fallen nearly 50% during 2008, and land value had declined an incredible 90% over that same period. Like single family home prices, these declines accelerated in the second half of 2008. For example, in just the last three months of the year, the condominium market declined by nearly 30%, and land value

plummeted by nearly 60%. In sum, there were accelerating declines in real estate values throughout 2008 in markets critical to TierOne's FAS 114 loans. Given these declines, any appraisal in these markets dated before the second half of 2008 was no longer a reasonable estimate of value by year end.

7. TierOne Used Stale Appraisals to Value FAS 114 Losses

Despite these market declines, at year end 2008, TierOne valued the collateral on most of its FAS 114 loans using stale appraisals. In Nevada, for example, only one lending relationship was valued using an appraisal from the second half of 2008. Even that appraisal was dated in July, making it nearly six months old at year end.

Exacerbating the stale appraisals was the fact that TierOne rarely took any discount to those appraisals to account for their age – despite a stated intent to do so. In a memo included in the audit workpapers and specifically reviewed by Aesoph and Bennett, TierOne claimed it would estimate collateral values on Nevada land and residential construction loans (which nearly all of the loans were) by discounting appraisals older than six months. This was consistent with TierOne's lending policy, which stated that "[i]n a rapidly escalating or deteriorating market, a[n appraisal] value may be valid only for a few months …." While these policies made good sense given the state of the markets, in fact TierOne almost never took a discount on stale appraisals. The below chart, excerpted from the report of the Division's expert witness, Dr. Anjan Thakor, compares the market declines with the discounts on the Nevada loans evaluated under FAS 114. The chart details the age of the various appraisals on the Nevada loans ("Appraisal Date") and then notes the discount, if any, applied by the bank ("Discount Applied by TierOne in FAS 114") and the comparable decline in the market, calculated by averaging the various relevant third-party indices ("Mean Post-Appraisal Cumulative Decline"):

Borrower Relationship	Loan Number	City	Appraisal Date	Discount Applied by TierOne in FAS 114	Mean Post-Appraisal Cumulative Decline
Clarke County					
Brother Sonny/ Jericho Heights		Boulder City	11/20/06	0.00%	-41.90%
		Las Vegas	Oct-06	0.00%	-41.98%
		Henderson	12/12/07	0.00%	-33.68%
Carlos Escapa Group 1		Las Vegas	4/02/08	0.00%	-21.75%
	0	Las Vegas	3/17/08	0.00%	-26.48%
		Las Vegas	3/17/08	0.00%	-26.48%
Carlos Escapa Group 2		Las Vegas	3/17/08	0.00%	-26.48%
		Las Vegas	3/17/08	0.00%	-26.48%
		Las Vegas	3/18/08	0.00%	-26.48%
		Las Vegas	3/24/08	0.00%	-26.48%
		Las Vegas	8/16/07	0.00%	-37.98%
		Las Vegas	8/16/07	0.00%	-37.98%
		Las Vegas	3/17/08	0.00%	-26.48%
Clearwater Estates		Las Vegas	4/18/08	0.00%	-21.75%
Grand Teton		Las Vegas	3/17/08	0.00%	-26.48%
		Las Vegas	3/17/08	0.00%	-26.48%
		Las Vegas	3/17/08	0.00%	-26.48%
HDB LLC		Las Vegas	5/28/08	10.00%	-37.02%
		Las Vegas	5/28/08	10.00%	-37.02%
MME LLC		Henderson	4/16/08	0.00%	-21.75%
Mohave Sun		Las Vegas	12/18/06	50.00%	-41.85%
Rising Sun		Las Vegas	5/05/08	0.00%	-21.75%
		Las Vegas	5/05/08	0.00%	-21.75%
		North Las Vegas	5/05/08	0.00%	-21.75%
Structured Homes		Las Vegas	4/30/08	0.00%	-21.75%
The Pueblos Partners		North Las Vegas	7/14/08	0.00%	-27.73%
		North Las Vegas	Secured by same collateral as loan '9680		
The Stratton Group		Henderson	1/04/08	0.00%	-43.11%
Town Vistas		Las Vegas	4/21/05	0.00%	-54.60%
Nye County					
Celebrate 50		Pahrump	11/01/06	55.00%	-42.70%
Double M Construction		Pahrump	11/01/06	50.00%	-42.70%

For some of these loans, there was a "cushion" between the value of the collateral and the value of the loan that would allow for some deterioration in collateral value before any losses would be required. However, as a threshold matter, nine of the 15 Nevada borrower relationships, totaling approximately $50 million in loans, were impaired with no cushion, meaning any decline in collateral value (above any discount TierOne had already applied) would have resulted in additional losses. Further, the cushion on a specific loan or lending relationship was often smaller than the reported market drop. For example, while the loans denoted in the above chart as "Carlos Escapa Group 2" had a roughly 12 percent cushion, markets had fallen 28 to 38 percent since the March 2008 and August 2007 appraisals. This lending relationship was significant, with a nearly $12 million book value at year end. Discounting these appraisals by the market declines would have resulted in more than $2 million in additional required losses.

In sum, despite the fact that TierOne's FAS 114 portfolio was increasing and the markets were plummeting, at year-end 2008 TierOne valued many of its FAS 114 loans using stale, undiscounted appraisals. This created a significant risk of understating loan losses and misstating the ALLL.

C. Respondents Knew of the Risk Related to the ALLL

In planning the 2008 audit, respondents knew the ALLL was a high-risk account, and identified it as such. Indeed, the ALLL and the related provision for loan losses were the only balance sheet or income statement accounts identified as having both a high inherent risk and a risk of fraud. The ALLL was also identified as one of only three risks at the financial statement level that could result in a material misstatement or material weakness in internal control. Notably, the other two revenue-related accounts were required to be considered a fraud risk on every audit engagement. Put simply, respondents acknowledged the ALLL was a high risk, if not

the highest risk area of the audit. However, despite claiming to recognize the risk, the audit procedures over the first of the two elements of the ALLL – the FAS 114 loans – were perfunctory at best.

D. Respondents Performed Perfunctory Audit Procedures

Most of the procedures performed over the ALLL were aimed at the second element of the ALLL – the FAS 5 loans. As for the FAS 114 element, the audit work papers list five procedures performed. Essentially, the audit team obtained and reviewed the FAS 114 analyses prepared by TierOne, "ticked and tied" the calculations to prior test work or the overall ALLL account, and met with management to discuss the collateral values used in the FAS 114 calculations. Despite market declines, if the appraisal used in a FAS 114 calculation was dated within the past year, the auditors accepted it as "current," regardless of the market the loan was in. According to the audit work papers, only if the appraisal was older than a year did the auditors "inquire[ ]" of management – that is, obtain management representations – regarding whether the appraisal was discounted, and if not, why not.[1]

These procedures fell well short of professional standards given the risks associated with the ALLL and TierOne's FAS 114 loan portfolio. Audit standards require a risk-based audit approach: the riskier the area, the more reliable the evidence must be, and the more evidence must be obtained to corroborate management's explanations. Management representations are never a substitute for procedures necessary to form an audit opinion. Such representations were

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[1] The workpapers also note the auditors "[l]everaged" from the work done by others, including KPMG's financial risk management credit specialist, Sandra Washek. However, this work was generally irrelevant to the issues in this case – the valuation of collateral and estimation of loan losses on the FAS 114 loans. For example, while Ms. Washek looked at TierOne's methodology for its FAS 114 loans, she was not responsible for auditing the collateral values or loan losses on those loans.

particularly weak evidence in this audit, given the significant risks surrounding the ALLL account, management's incentive to understate loan losses to meet the bank's elevated capital requirements, the history of management bias, and OTS's stinging rebukes of the bank's "inept" credit administration practices and "exceptionally poor" management performance.

The cursory nature of these procedures was underscored by the auditors' blanket assumption that a year-old appraisal was "current" in all circumstances. As noted above, in Nevada, which was home to the majority of TierOne's loans evaluated under FAS 114, single-family home values had fallen more than 30 percent in 2008, condominium values had fallen nearly 50 percent, and land values had declined an astonishing 90 percent. Most of these declines occurred in the second half of the year. Indeed, TierOne itself claimed, in a memo reviewed by respondents, that it would discount appraisals in Nevada that were more than six months old (although the evidence shows they often did not). Under these circumstances, assuming a year-old appraisal was "current" was simply unreasonable.

Further, the 2008 audit work papers document little if any evidence gathered by the auditors to test this high-risk area. For example, for one Florida-based lending relationship with undiscounted appraisals dated in October 2007, the work papers contain only the following: "KPMG noted, based on current information TierOne did not think it was necessary to discount this appraisal. KPMG recommended that management order a new appraisal in order to assess future reserves, if necessary." There is no indication of what management told the auditors, what "current information," if any, the auditors reviewed, or any other basis for the reasonableness of relying on a 14-month old appraisal in a market that, according to the independent market data, had declined more than 30 percent.

Similarly, for one Las Vegas-based lending relationship with a May 2008 appraisal, the work papers note simply state "KPMG reviewed appraisals in previous quarters, noting these [fair value] amounts are appraisal values less a 10% discount. KPMG noted based on market conditions this discount appears reasonable." There is no evidence of what "market conditions" the auditors considered. In fact, these loans were related to a condominium project; the Las Vegas condominium market had fallen nearly 40 percent since the time of the appraisal. Had that market decline been applied to the appraised value, it would have revealed more than $6 million in additional loan losses, despite the 10 percent discount. This actual, independent evidence underscores the unreasonableness of failing to look beyond management's representations.

As terse as these audit notes are, they represent the most in-depth test work recorded in the audit work papers. In most cases, the auditors simply underlined the date of the appraisals or noted that they "agreed" the valuation used in the FAS 114 analysis to the underlying appraisal. In investigative testimony, respondents attempted to explain this lack of evidence by claiming they would only document disagreements with management's representations regarding collateral values. Not only is such a claim inconsistent with audit standards, which require documentation of the evidence obtained, it is also significant for the fact that no such disagreements were noted. In other words, despite events throughout the year that demonstrated TierOne was underestimating its loan losses, and despite the fact that at year end TierOne was often using stale, undiscounted appraisals to value FAS 114 loans, the auditors concluded that each and every estimate they reviewed was reasonable. This is further evidence of the perfunctory nature of the audit procedures.

That no disagreements were noted was particularly troubling given the significant variance between the collateral values used by management and the values indicated by the

independent, third-party evidence of market declines. Though not documented in the FAS 114 procedures work paper, respondents claim they would have reviewed third-party market data, such as the Case-Shiller index, in assessing the reasonableness of management's estimates. But as discussed above, third-party market data showed that key markets had fallen precipitously. For example, in Nevada, values had declined twenty to forty percent since the dates of the appraisals used to estimate loan losses at year end. Had respondents actually reviewed third-party market indices, the results should not have given them comfort, but rather should have been another significant red flag.

Management's year-end valuation estimates should have been called into further question by revelations during the auditors' review work in early 2009. In the first and second quarters, the auditors learned that a number of FAS 114 loans had new appraisals dated after year-end but prior to the issuance of their year-end audit report – a problem in and of itself, and which respondents failed to investigate. These appraisals often showed significant additional loan losses. For example, the auditors learned during their first quarter review work that a new appraisal had come in on a Nevada property called Celebrate 50. At year end, TierOne had applied a 55 percent discount to a 2006 appraisal, bringing the fair value down to $5.74 million. However, the new appraisal, dated January 27, 2009, reported the collateral was worth $3.45 million – a 40% drop in the value management had estimated just weeks before. This new appraisal resulted in nearly $2 million in additional loan losses.

In sum, at the time of the audit there was significant evidence of the risks inherent in the FAS 114 element of the ALLL (and the ALLL itself), of management's bias in overestimating collateral values and underestimating loan losses, of the plummeting real estate values in markets critical to the FAS 114 loans, and of management's reliance on stale, undiscounted appraisals to

estimate FAS 114 loan losses. This should have alerted the auditors to the real possibility of additional, inherent losses in TierOne's FAS 114 loan portfolio at year end. Even so, the auditors concluded that year-old appraisals were reasonable estimates of value, despite the evidence to the contrary, and relied primarily on management's representations to test this high risk area. These perfunctory procedures were highly unreasonable.

E. Respondents Failed to Identify or Test Key Internal Controls

In addition to the cursory substantive test work over the FAS 114 element of the ALLL, respondents' internal control testing fell short in that same area. As with substantive testing, risk assessment drives the audit of internal control: the greater the risk, the more persuasive the evidence must be to demonstrate that the controls are effective. The auditors identified as "higher" risk points that the ALLL may be improperly valued and, specific to the FAS 114 element, that collateral securing loans may be overvalued. However, the auditors failed to identify or test a control relevant to a critical component of this risk: that collateral was overvalued as a result of using stale appraisals to estimate losses on FAS 114 loans.

The auditors independently tested several controls related to the ALLL, but none of those controls addressed this key risk. Rather, the auditors relied upon inquires of management, high level controls, and an appraisal review process, none of which addressed the risk associated with management's use of stale appraisals in rapidly declining markets. Exacerbating these problems, the auditors' control testing also failed to consider whether TierOne was following its own policies for updating appraisals on FAS 114 loans, policies that required all loans be supported by current appraisals and further provided that "[i]n a rapidly escalating or deteriorating market, a value may be valid for only a few months …." As discussed above, the appraisals on many of TierOne's FAS 114 loans ran afoul of these requirements.

Absent the identification and testing of an effective control to address the key risk of overvaluing collateral on FAS 114 loans, the auditors had no reasonable basis for concluding that TierOne maintained effective internal controls. Concluding that controls were effective despite failing to identify or test a control over a critical risk area further demonstrates the unreasonableness of respondents' conduct.

F. KPMG Issued an Unqualified Audit Opinion

Despite the significant failings outlined above, KPMG issued clean audit opinions as a result of the 2008 audit. KPMG reported that it had conducted its audit in accordance with relevant professional standards. It further reported that, "[i]n our opinion, the consolidated financial statements [of TierOne] present fairly, in all material respects, the financial position of TierOne Corporation and subsidiaries as of December 31, 2008 …." As to internal controls, KPMG similarly reported that "[i]n our opinion, TierOne Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008 …."

G. TierOne Failed as a Result of Losses Inherent In Its Loan Portfolio

TierOne's practice of relying on stale appraisals to estimate losses on FAS 114 loans came to an end when the OTS returned for its regularly scheduled 2009 examination. Prompted by the OTS, TierOne ordered a significant volume of new appraisals on impaired loans in August and September 2009. These appraisals revealed massive unrecognized loan losses. Indeed, as a result of its examination, the OTS concluded that TierOne had engaged in "unsafe and unsound practices that deferred the recognition of problem assets and losses," including the "fail[ure] to order appraisal reports when prudent or required."

In October 2009, TierOne disclosed that the OTS was requiring it to restate second quarter loan losses, and further disclosed approximately $14 million in additional loan losses as

of June 30, 2009. As a result of these additional losses, TierOne fell below the OTS-required elevated capital ratios as of the second quarter. Shortly after this restatement, TierOne disclosed another $120 million in loan losses as of September 30, 2009. These losses pushed the bank well below the elevated capital ratios, and even below the ratios required to be deemed a "well capitalized" institution. Unable to recover, in June 2010 TierOne was closed by the OTS, and the FDIC was appointed as the receiver over the bank's assets.

In April 2010, KPMG resigned as TierOne's auditor. KPMG advised TierOne that it was withdrawing its year-end 2008 audit opinion and internal control assessment. As summarized in TierOne's 8-K filing reporting the resignation, KPMG withdrew its audit opinion related to the 2008 financial statements "because such financial statements contain material misstatements related to certain out of period adjustments for loan loss reserves," and similarly withdrew its 2008 internal control assessment "due to a material weakness in internal control over financial reporting related to the material misstatements."

In July 2011, the Office of the Inspector General of the Department of the Treasury completed a review of the causes of TierOne's failure. That report concluded that TierOne failed primarily because of loan losses in its construction and land development loan portfolio, and particularly those loans located in Las Vegas. It also found that, despite TierOne reducing its lending activity in 2008 in response to the economic downturn, the risk of loss was already embedded in the loan portfolio. That risk eventually manifested itself in the substantial loan losses that toppled the bank.

Like the OTS, the OIG report also found that TierOne had delayed the recognition of problem loans and loan losses. Specifically, the report noted that

> TierOne's management often failed to order updated appraisals when modifying loans or when material deterioration in property values was evident. In many

> instances, the original appraisal report was over 2 years old. OTS and TierOne's internal auditors identified this issue in 2008 but TierOne management took no corrective action to improve the appraisal practices until prompted again by OTS examiners during the 2009 examination. After obtaining updated appraisals, TierOne management recorded $120 million in loan loss provisions ....

Notably, a key event between the OTS's identification of TierOne's untimely recognition of loan losses in 2008, and the ultimate disclosure of crippling loan losses in 2009, was respondents' year-end audit, which concluded that TierOne's loan loss estimates were reasonable and resulted in an unqualified audit opinion. This clean audit opinion does not square with these other events.

IV. ARGUMENT

A. Relevant Provisions of Rule 102(e)

Under Rule 102(e) of the Commission's Rules of Practice, the Commission may censure an accountant or deny him the privilege of appearing or practicing before the Commission temporarily or permanently, if the accountant is found to have engaged in improper professional conduct. 17 C.F.R. § 201.102(e). Because a negligent auditor "can do just as much harm to the Commission's processes as one who acts with an improper motive," negligent conduct is sufficient for Rule 102(e) proceedings. *See Amendment to Rule 102(e) of the Commission's Rules of Practice ("Amendment to Rule 102(e)")*, Fed. Reg. 57164, 57167 (October 26, 1998); *Dearlove v. SEC*, 573 F.3d 801, 805 (D.C. Cir. 2009).

Improper professional conduct includes two types of negligent conduct: (1) "[a] single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances which an accountant knows, or should know, that heightened scrutiny is warranted"; and (2) "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." 17 C.F.R. § 201.102(e)(iv)(B). Applicable professional standards

consist of, among other things, those standards articulated or adopted by the PCAOB, including GAAS, GAAP, and SEC rules. *See Amendment to Rule 102(e)*, Fed. Reg. at 57166; *Dearlove*, 573 F.3d at 804.

In Rule 102(e) proceedings, the Division need not show that the accountant's improper conduct caused any harm or resulted in the filing of a false or misleading document. *Amendment to Rule 102(e)*, Fed. Reg. at 57168; *Gregory M. Dearlove*, 2008 WL 281105, at *14, n.51 (Rel. No. 34-57244, Jan. 21, 2008). In addition, an accountant's subjective good faith is not a defense to a claim that he engaged in improper professional conduct based on negligence. *Amendment to Rule 102(e)*, Fed. Reg. at 57170.

B. Respondents Violated Basic Professional Standards in Conducting the 2008 Audit

PCAOB standards require auditors to exercise due professional care in conducting an audit, maintaining an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence." *Wendy McNeeley*, 2012 WL 6457291, at *9 (Rel. No. 34-68431, December 13, 2012). In the face of red flags or inconsistent evidence, an auditor should exercise professional skepticism and investigate further to reconcile possible inconsistencies. *Id.* at 9-13. Such red flags should "arouse suspicion and call for focused investigation." *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005). Where a risk of material misstatement or fraud exists, auditors must increase their professional care and skepticism. *Dearlove*, 2008 WL 281105, at *6; *Kevin Hall and Rosemary Meyer*, 2009 WL 4809215, at *7 (Rel. No. 34-61162, December 14, 2009). Simply put, "areas that present more risk will demand more attention." *Dearlove*, 2008 WL 281105, at *29.

PCAOB standards also require auditors to obtain sufficient competent evidential matter, or "evidence sufficient to afford a reasonable basis for an opinion with respect to the financial

statements under review." *McNeeley*, 2012 WL 6457291, at *13. It is axiomatic that an auditor should not rely solely on management representations. *James Thomas McCurdy*, 2002 WL 1841565, at *8 (August 13, 2002). In addition, auditors "may not be satisfied with less than persuasive evidence merely because they believe that management is honest." *McNeeley*, 2012 WL 6457291, at *13. These admonitions are even more urgent in circumstances requiring heightened scrutiny. *Id.* While an auditor exercises judgment in deciding the evidence to obtain, "that judgment must be 'guided by sound' auditing principles, among which are a 'thorough . . . search for evidential matter.'" *McCurdy*, 396 F.3d at 1263.

Aesoph and Bennett failed to exercise due care and professional skepticism with respect to the 2008 audit, specifically with respect to TierOne's FAS 114 loan losses, a material part of its ALLL.[2] In the face of significant red flags – namely the OTS report, the losses reported by TierOne during 2008, the updated appraisals reflecting declines in collateral values, the declining real estate market, and the stale appraisals at year-end – the auditors should have been alert to the real possibility of additional loan losses inherent in TierOne's FAS 114 loan portfolio at year end, and should have increased their scrutiny of management's estimates. However, respondents failed to sufficiently investigate and corroborate the basis for management's estimates of the FAS 114 collateral values and related loan losses. Instead, they relied primarily on management's representations and failed to obtain sufficient competent evidence to support their conclusion that the estimates were reasonable. In addition, they failed to identify and test a

[2] In his report, the Division's expert John Barron details respondents' violations of professional standards. Mr. Barron will testify concerning these violations. The Division's description herein constitutes a summary for sake of expediency. The Division will fully address respondents' violations in its post-hearing briefing.

control that was effective in preventing or detecting a material misstatement caused by the overvaluation of collateral related to FAS 114 loans.

Moreover, Aesoph and Bennett relied on management's representations in the face of contrary evidence. If a representation by management is contradicted by other audit evidence, an auditor "should investigate the circumstances, and consider the reliability of the representation made." *McNeeley*, 2012 WL 6457291, at *12. As indicated above, the auditors claim they were aware of third-party evidence reflecting significant market declines in many of TierOne's markets, such as Nevada, yet they failed to reconcile this evidence with TierOne failures to sufficiently discount, or indeed discount at all, stale appraisals in those markets. Similarly, the auditors encountered evidence of significant management bias in estimating TierOne collateral values and loan losses. This bias was indicated by the OTS report findings and the updated appraisals TierOne received during 2008. Aesoph and Bennett did not reconcile this evidence of bias with TierOne's failures to sufficiently discount stale appraisals. This failure to properly investigate and reconcile these inconsistencies also violated professional standards.

Further, KPMG's audit working papers failed to document any evidence Aesoph and Bennett relied upon to support TierOne's estimates of collateral values and loan losses beyond management's representations. Rather, respondents testified that they *would have* documented any disagreements with management. However, the requirement for audit documentation cannot be trivialized. "[A]udit documentation must 'contain sufficient documentation to enable an experienced auditor, having no previous connection with the engagement,' to 'understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached,' with no provision for recourse to external sources." *Hall and Meyer*, 2009 WL 4809215, at *9; AS 3, ¶¶ 5, 6. 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." *McNeeley*, 2012 WL 6457291, at *13. Because Aesoph and Bennett failed to document their working papers with sufficient evidence supporting TierOne's estimates of collateral values and loan losses on its FAS 114 loans – which suggests that no such evidence exists – it should be found that their audit work in this area was critically deficient.[3]

C. Respondents' Audit Failures and Professional Violations Taken as a Whole Constitute a Single Instance of Highly Unreasonable Conduct

The Commission has found an accountant's conduct to be highly unreasonable "when he fails to employ heightened scrutiny with regard to matters that are 'important or material, or when warning signals or other factors should alert an accountant' to a heightened risk." *Philip L. Pascale*, 2005 WL 636868, at *11 (Rel. No. 34-51393, March 18, 2005), citing *James Thomas McCurdy*, 2004 WL 210606, at *8-9 (Rel. No. 34-49182, Feb. 4, 2004), *aff'd*, *McCurdy v. SEC*, 396 F.3d 1258 (D.C. Cir. 2005). The "highly unreasonable" standard is an intermediate standard that is "higher than ordinary negligence but lower than the traditional definition of recklessness." *See McCurdy*, 2004 WL 210606, at *8-9; *Amendment to Rule 102(e)*, Fed. Reg. at 57167. However, the standard is not one of subjective intent. Rather, it is an objective standard that is measured by the degree of the departure from professional standards and not the intent of the accountant. *Amendment to Rule 102(e)*, Fed. Reg. at 57167. The "heightened scrutiny" provision is similarly an objective standard that applies to important or material matters, areas of heightened risk, or as set forth in applicable professional standards. *Id.* at 57168; *McCurdy*, 2004 WL 210606, at *8-9. A single instance of highly unreasonable conduct as defined by the Rule

[3] Aesoph and Bennett's work on other audit areas does not excuse their audit failures relating to TierOne's FAS 114 loan loss estimates. For example, in *Dearlove*, 2008 WL 281105, at *3, 38, the Commission found an auditor liable for improper professional conduct despite the fact that his audit firm devoted 21,000 hours to the audit and Dearlove himself spent over 700 hours.

presumptively demonstrates a lack of competence to practice before the Commission and constitutes improper professional conduct. *Amendment to Rule 102(e)*, Fed. Reg. at 57166.

There can be no dispute that the audit of the ALLL was an area requiring heightened scrutiny: the auditors themselves identified it as one of the highest, if not the highest, risk account in the audit. In addition, Aesoph and Bennett encountered serious red flags, such as the OTS report findings, the evidence of management bias, and the dramatic market declines. These red flags only heightened the risk regarding TierOne's ALLL and its FAS 114 loan loss estimates, requiring increased scrutiny. Despite these significant risks, however, Aesoph and Bennett's overall audit work concerning the ALLL – including the assessment of internal control over financial reporting and the substantive test work – fell well short of audit standards as described above. The Commission has previously found that a failure to obtain sufficient competent evidence where heightened scrutiny is warranted constitutes a single instance of highly unreasonable conduct under Rule 102(e). *McCurdy*, 2004 WL 210606, at *9. Similarly, Aesoph and Bennett's audit failures deviated from professional standards to a significant degree, meeting the highly unreasonable standard and presumptively demonstrating their lack of competence and improper professional conduct.

D. Respondents' Audit Failures and Professional Violations Constitute Repeated Instances of Unreasonable Conduct

As indicated, repeated instances of unreasonable conduct can also constitute a lack of competence and improper professional conduct. The standard "unreasonable conduct" requires only ordinary or simple negligence. *Hall and Meyer*, 2009 WL 4809215, at *7; *Amendment to Rule 102(e)*, Fed. Reg. at 57169. Repeated instances of unreasonable conduct may be demonstrated by as few as two separate violations occurring within one audit and one financial statement account. *Hall and Meyer*, 2009 WL 4809215, at *7. Under this prong of the Rule, lack

of competence is not presumed as a result of the violations. However, more than one violation of the applicable professional standards ordinarily will indicate a lack of competence. *Amendment to Rule 102(e)*, Fed. Reg. at 57169.

Aesoph and Benett's audit failures satisfy the test for repeated instances of unreasonable conduct. With respect to numerous FAS 114 loans, respondents failed to exercise due care and professional skepticism, and failed to obtain sufficient competent evidence relating to TierOne's FAS 114 collateral values and the related loan loss estimates, a material portion of its ALLL. They also failed to identify and test a control that was effective in preventing or detecting a material misstatement caused by the overvaluation of collateral related to FAS 114 loans. Given the number of violations by Aesoph and Bennett in a high risk audit area that required increased scrutiny, the evidence supports a finding of lack of competence and improper professional conduct.

E. Management's Fraud at TierOne Does Not Excuse Aesoph and Bennett's Improper Audit

Respondents are expected to argue that the fraud at TierOne should be taken into consideration in determining whether they committed improper professional conduct. However, the issue in this proceeding is whether respondents conducted their 2008 audit in accordance with applicable professional standards. The proper evaluation is what the auditors did based on the information they knew or should have known, not based on information that may have been withheld from them by TierOne's management. As the Commission has explained before in a similar context, an auditor:

> . . . is not a guarantor of the accuracy of financial statements of public companies, but the Commission and the investing public rely heavily on auditors to perform their tasks in auditing public companies diligently and with a reasonable degree of competence. Therefore, although we do not know whether [the] fraud would have

> been uncovered had [respondents] fulfilled [their] professional duties in conducting the audit, . . . that is not relevant to our inquiry.

Wendy McNeeley, 2012 WL 6457291, at *12 (internal quotations omitted). *See also Touche Ross & Co.*, 1974 WL 161425, at *1 (Rel. No. 33-5459, February 25, 1974) (deception did not relieve auditor of its responsibility to perform audits in conformity with GAAS); *Amendment to Rule 102(e)*, Fed. Reg. at 57170 (an accountant's subjective good faith is not a defense to a claim that he engaged in improper professional conduct based on negligence). Since deception of auditors is not a defense to these proceedings, such evidence should be given little if any consideration.

V. RELIEF REQUESTED

The Division requests remedial action consistent with Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice. Such remedial action may include, without limitation, censuring or denying, temporarily or permanently, the privilege of appearing or practicing before the Commission. Based on the violations, remedial action is warranted. The Division will recommend specific remedial action in its post-trial briefing or at the hearing if requested by the law judge.

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Respectfully submitted,

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