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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 PRE-HEARING BRIEF

August 29, 2013

George B. Curtis
Monica K. Loseman
Counsel for John J. Aesoph
GIBSON, DUNN & CRUTCHER LLP
1801 California St., Ste. 4200
Denver, CO 80202
(303) 298-4743 (Curtis)
(303) 298-5784 (Loseman)
gcurtis@gibsondunn.com
mloseman@gibsondunn.com

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I.
INTRODUCTION AND OVERVIEW

Respondent John Aesoph, the KPMG LLP partner responsible for the 2008 audit of TierOne Corporation ("TierOne" or "Bank"), is a hard-working, experienced audit professional, and a proven mentor to his staff, who should not be barred from appearing before the Commission. Mr. Aesoph's conduct, with regard to both the 2008 audit and the circumstances that led Mr. Aesoph and KPMG to resign as TierOne's auditor, demonstrates not only his competence to practice before the Commission but a level of professional skepticism that is entirely consistent with the Commission's mission of investor protection.

As engagement partner, Mr. Aesoph was responsible for planning, supervising, and executing the 2008 audit. He assembled and supervised a team of audit professionals and subject matter experts who diligently gathered and analyzed audit evidence specifically related to loan losses, including risks specific to impaired loans. In an environment more challenging than many highly experienced auditors will ever see, Mr. Aesoph and his engagement team conducted the audit with professionalism, skepticism, and due care. This pre-hearing brief previews the evidence that will show how the audit he supervised met all relevant professional standards under uniquely challenging circumstances.

The Order Instituting Proceedings ("OIP") challenges the auditors' testwork around one particular segment of TierOne's loan portfolio: the so-called "FAS 114 loans." Pursuant to Statement of Financial Accounting Standards No. 114 ("FAS 114"),[1] TierOne evaluated these loans to determine whether they were impaired (*i.e.*, whether it was "probable" that TierOne

[1] Citations to accounting guidance are to versions applicable during the relevant timeframe. The full text of this guidance is set forth in Respondents' Joint Exhibits ("Resp'ts Exs.") 44–48 and 64–65.

would not collect all payments according to the terms of the loan agreement) and, if impaired, to measure the extent of incurred loss. For those deemed to be impaired under FAS 114, the Bank measured this probable loss by estimating the fair value of the collateral. No off-the-shelf formula was available to determine the fair value of these non-homogenous pieces of real estate. Consistent with the requirements of FAS 114, TierOne instead estimated the collateral fair value and resulting charge-offs and reserves on a loan-by-loan basis. The Division claims that Mr. Aesoph and Respondent Darren Bennett, the senior manager on the TierOne audit, "merely rubber-stamped TierOne's collateral value estimates and ignored the red flags surrounding the Bank's troubled real estate loans."[2] The evidence will show why these allegations are entirely unfounded.

The Division, in making its allegations, first points to a supposed disconnect between market trends and the Bank's valuation of the FAS 114 loans. But this alleged "bias" or "red flag" is based on inexcusably bad math by both the Division and its audit expert, John Barron. Proper comparisons show that the Bank's FAS 114 loan losses hewed remarkably close to reported market trends throughout 2008. See IV, *infra*. The auditors noted that these trends, documented in third-party market studies that they obtained and evaluated in the course of the audit, were consistent with the relevant audit findings for 2008.

That leads into the Division's second error: ignoring the great bulk of procedures the audit team actually performed and the careful attention the auditors paid to the impaired loans and relevant market conditions in 2008. The audit work papers and testimony will demonstrate, in particular, that the audit team followed the requirement to assess TierOne's ALLL as a whole,

[2] Press Release No. 2013-2, U.S. Sec. & Exchange Comm'n, SEC Charges Two KPMG Auditors for Failed Audit of Nebraska Bank Hiding Loan Losses During Financial Crisis (Jan. 9, 2013).

including its controls over that allowance, and paid particularly close attention to the FAS 114 accounting at issue here. For instance, the audit team specifically tested TierOne's process for identifying and evaluating impaired loans and obtained Management's documented loss analysis on every single loan TierOne evaluated for impairment under FAS 114—186 loans spanning 55 borrower relationships. That analysis was presented through Management's "FAS 114 template," copies of which were included in the work papers. The team reviewed each and every FAS 114 template, tying the estimated charge-offs and reserves to the books and records, and comparing current estimates to those made in prior periods. The team then selected a subset of those templates for detailed testwork in which they examined the Bank's comprehensive loan files to obtain evidence supporting individual estimates, and to assess whether TierOne's estimation process employed a proper mix of information available under the circumstances, as accounting guidance dictates.

Reasonable minds may differ on the many judgment calls the auditors made regarding Management's nuanced fair value estimation process, but nobody who examines the full record could call this a rubber-stamp audit. Sandra Johnigan, an audit profession leader with extensive experience auditing financial institutions—and an expert upon whom the Commission itself has relied—conducted a comprehensive review of the KPMG work papers that document this extensive and thorough audit. In her expert opinion, the work by Messrs. Aesoph and Bennett and their engagement team, including the careful attention paid to TierOne's FAS 114 estimates, fully complied with professional standards.

The Division simply ignores the bulk of the audit work performed, work that Ms. Johnigan considered and reviewed, and then mis-describes the accounting principles and auditing standards governing FAS 114 loans. In the Division's view, no FAS 114 estimate could be

reasonable without either a "current" real estate appraisal or a generic, market statistic driven discount for each piece of collateral underlying all 186 of TierOne's FAS 114 loans. The Division cites no guidance or authority for this alleged *per se* rule, because there is none. Even under normal market conditions, the availability of appraisals that are "current" (an ambiguous term that the Division leaves undefined) is but one piece of information to consider in the overall mix.

The fact that market conditions in 2008 were anything but normal further compounds the error in the Division's assumption. In the same distressed real estate markets on which the Division's allegations focus, foreclosures and other forced sales in the second half of 2008 dominated the market sales data. Under FAS 157—the key accounting guidance on fair valuation—such distressed sales are not indicative of fair value. "Fair value" is the amount at which an asset would be expected to sell in a hypothetical "orderly transaction between market participants" who are "willing to transact." FAS 157 ¶¶ 5, 10. A "forced transaction (for example, a forced liquidation or distress sale)," by definition, does not represent fair value under GAAP. *Id.* ¶ 7. The auditors therefore satisfied their professional obligations by looking to, and locating, evidential matter beyond the availability of new appraisals. Astonishingly, the OIP never once mentions FAS 157, the accounting standard that defines fair value. And the Division's auditing and economic experts completely ignore its import.

Chris James, a Professor of Finance and Economics at the University of Florida and currently a visiting scholar at the Federal Reserve Bank in San Francisco, documents this serious factual flaw in the Division's premise. He will explain that appraisals during this time period, especially in markets such as Las Vegas where liquidation sales and foreclosures loomed large, themselves were often infected by potentially inaccurate assumptions. This is why, in evaluating

TierOne's ALLL, the auditors obtained evidence that the Bank's FAS 114 loans were evaluated individually, "based on current information and events," using methods "practical in the[] circumstances." FAS 114 ¶¶ 8, 11.

The Division's allegations suffer a further significant weakness: a refusal to recognize a thorough-going fraud, perpetrated by TierOne Management, that directly affected the 2008 audit procedures and their results. Strangely, while the Division does not hesitate to ignore the fraud on the auditors in this forum, the Commission has directly asserted it in another. In fact, the Division's own multi-year investigation has shown that TierOne Management engaged in a brazen deception during 2008 in which high-level Bank personnel intentionally concealed information showing even greater losses than those recognized in the Bank's ALLL and charge-offs for 2008. This collusive fraud tainted the Bank's individual assessments of its FAS 114 loans and the auditors' testwork over them. The Commission itself has gone on record that key members of TierOne's Management "made false representations to" the auditors by "falsifying" FAS 114 documentation and "failing to inform the auditor[s] of appraisals and other valuation information that demonstrated significant declines in the collateral underlying the bank's impaired loans." Resp'ts Ex. 235, Complaint ¶¶ 97–98, *SEC v. Langford*, No. 12-cv-344 (D. Neb. Sept. 25, 2012) ("Langford Complaint").

Yet the Division has brought charges against the very person who brought these facts to light and assisted the Commission Staff in its investigation. Mr. Aesoph and his team's diligence in the second half of 2009 uncovered critical evidence that TierOne's Management hid from KPMG, prompting Mr. Aesoph to lead KPMG's internal review and ultimate resignation from the TierOne audit and to withdraw the firm's 2008 audit opinion. The Division would use

subsequent developments like this to second-guess the auditors' real-time judgments in 2008, but the Commission's Rules expressly bar that tactic.

Mr. Aesoph led an audit team that exercised professional judgment, appropriate skepticism, and due care, all in the midst of a highly challenging economic environment and, as it turns out, a concerted fraud. He represents no threat to the Commission's processes. To the contrary, an auditor with Mr. Aesoph's unique experience, including detection and exposure of fraud by a large, sophisticated client, is an asset the Commission should be reluctant to lose. The charges should be dismissed.

II.
COMMISSION RULE 102(e)

The gravity of a Rule 102(e) sanction "should not be underestimated." *Checkosky v. SEC*, 23 F.3d 452, 479 (D.C. Cir. 1994). A finding against the 41-year-old Mr. Aesoph could destroy "a way of life to which he has devoted years of preparation" and threaten his "entire livelihood." *Id.* (internal quotation marks omitted).

These potential results require the Division to meet a heavy burden. For instance, Rule 102(e) was "not intended to cover all forms of professional misconduct." Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164, 57165–66 (Oct. 26, 1998). Instead, its intended focus is on egregious lapses in professionalism evidencing a threat to the Commission's mission of protecting the investing public. *Id.* The facts presented in this proceeding will disprove any attempt by the Division to meet its burden of proof.

The Division does not allege "intentional or knowing" misconduct on the part of Respondents. It therefore must show either "[a] single instance of highly unreasonable conduct" or "[r]epeated instances of unreasonable conduct" that "indicate a lack of competence to practice

before the Commission."[3] Since this case boils down to supposed failures to exercise due care and skepticism in audit work related to a single aspect of TierOne's 2008 financial statements—loss reserves for the FAS 114 loan portfolio, contained within a single assertion (the ALLL)—the Division must show that Respondents' actions were "highly unreasonable," a burden that the Division's proof cannot meet.

One final point about the operation of Rule 102(e) bears mention. The Rule is not a license for the Division to play "Monday morning quarterback" with professional audit judgments by "evaluat[ing] actions or judgments in the stark light of hindsight"; the Rule "focuses instead on what an accountant knew, or should have known, at the time an action was taken or a decision was made." Amendment to Rule 102(e), 63 Fed. Reg. at 57168.

III.
BACKGROUND

A. Respondent John Aesoph and his Team of Professionals.

Mr. Aesoph was the partner in charge of KPMG's 2008 audit of TierOne's year-end financial statements and internal controls over financial reporting. He supervised the engagement team and bore final responsibility for the integrated audit. His 15-year career in the accounting profession to that date—13 of them auditing financial institutions—prepared him well for that role. As a partner at KPMG, Mr. Aesoph has focused his practice exclusively on financial institutions, and he has extensive experience with both publicly and privately traded banks, on the audits of which he has functioned as both engagement partner and concurring review partner.

Mr. Aesoph is the antithesis of a drive-by auditor or absentee partner. Throughout his years of work on TierOne audits, he acquired a deep understanding of the company and its

[3] Commission Rule of Practice 102(e), 17 C.F.R. § 201.102(e)(1)(iv)(B); *see also* 15 U.S.C. § 78d-3(b)(2).

accounting practices. As the financial crisis took hold and the markets grew more volatile, he recognized that loan losses would be a critical issue at TierOne, and during the 2008 quarterly reviews and the year-end audit, Mr. Aesoph reviewed a substantial number of work papers relating to TierOne's ALLL and charge-offs. For example, he reviewed each of the dozens of FAS 114 templates collected in the work papers and discussed those templates with his audit team at year-end. He paid particular attention to this audit area, monitoring the team's approach to testing TierOne's FAS 114 estimates and the evidence the audit team obtained. He relied on team members to bring to his attention significant accounting and auditing questions, and he assessed their significance in consultation with various members of the engagement team and internal specialists. AU § 311.12.[4]

Mr. Aesoph also regularly discussed developments at the Bank with his audit team, leveraging on-the-ground knowledge they gained during more than 2,000 hours on-site. Mr. Aesoph himself recorded 151.5 hours on the 2008 audit, a more than 35 percent increase over the 111.5 hours he devoted in 2007. And he spent nearly all of these hours on-site at TierOne, reviewing the work of the engagement team, discussing accounting issues with the client, and reviewing loan files and other audit evidence.

As engagement partner, Mr. Aesoph was "responsible for the assignment of tasks to, and supervision of, assistants." AU § 230.06. Because the economic environment in 2008 had become more challenging, with the accounting issues that faced TierOne growing more complex, Mr. Aesoph directed the audit team to intensify the audit procedures performed on the TierOne engagement. Resp'ts Ex. 3E, KPMGTO 3679, 3684–85, 3689; Resp'ts Ex. 3F, KPMGTO 3699;

[4] Citations to auditing standards are to interim and final standards adopted by the Public Company Accounting Oversight Board ("PCAOB") applicable to the relevant timeframe. These standards are included in the record as Respondents' Joint Exhibits 49–63.

Resp'ts Ex. 8A, KPMGTO 5173–74.[5] The change was substantial. During the 2008 audit and quarterly reviews, his team members recorded a total of 2,639.8 hours, a 50 percent increase over the 1,751.5 hours recorded for 2007.

Mr. Aesoph was well supported by several KPMG audit professionals, including: Terence Kenney, the SEC Reviewing Partner and Audit Practice Leader for the Financial Services Practice of KPMG's Chicago office; Respondent Darren Bennett, senior manager on the engagement team; Sandra Washek, a Financial Risk Management (FRM or Credit) Specialist; Hugh Kelly and Craig Stirnweis, Financial Regulatory Specialists; David Butler, KPMG's Western Regional Professional Practice Partner; and various economic valuation and forensics experts.

B. Relevant Accounting and Auditing Standards

1. The Allowance for Loan and Lease Losses (ALLL).

The ALLL Generally. The Division's allegations concern a single assertion in TierOne's 2008 financial statements: the allowance for loan and lease losses, or ALLL. Three main accounting events affect the ALLL: provisions, charge-offs, and loan recoveries. The Division and its audit expert address only the first. Their failure to consider charge-offs—current recognition of actual losses that decrease the ALLL—is a fundamental defect in their entire case. *See* IV, *infra*.

Two key attributes of the ALLL run through this case. *First*, the ALLL is an estimate laden with judgment. The chief task in determining the FAS 114 component of TierOne's ALLL

[5] The audit team's full quarterly and year-end work papers are set forth in Respondents' Joint Exhibit List. The year-end 2008 audit work papers consist of 12 separate binders. Each of these has been assigned a separate exhibit number (*e.g.*, Binder 1 is Exhibit 1), and certain work papers have been assigned a subletter (*e.g.*, work paper L-22, located in Binder 8, is Exhibit 8B).

was estimating fair value of the collateral for each loan. There is no "right" answer when it comes to estimating how much a given property might sell for on a hypothesized date in a hypothetical market of willing, able, and properly informed buyers and sellers. The ALLL estimate is a product of judgments derived from mixes of reasonably available information. In the case of TierOne's FAS 114 loans, the need to exercise judgment permeated this process, because a separate estimate of fair value was calculated for each impaired loan. Thus, as explained below, the component of the ALLL on which the Division focuses its allegations was an aggregation of multiple estimates requiring multiple judgments.

Second, the ALLL measures probable existing loss, not loss predicted to occur after the close of a reporting period. "[E]ven though it may be probable based on past experience that losses will be incurred in the future," credit losses "should not be recognized before it is probable that they have been incurred." FASB Emerging Issues Task Force Topic No. D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio ("EITF D-80") at Ex. D-80A. Thus, the relevant question is not "how much is the Bank going to lose" but "how much has the Bank already lost" as of a reporting date. As a result, and by design under GAAP, the ALLL lagged what market experts predicted or anticipated at any given time.

FAS 5. The vast majority of TierOne's loan portfolio—around 93 percent of the total net loan balance—consisted of non-impaired loans reserved for under FAS 5. FAS 5 required TierOne Management to group similar loans according to common risk characteristics, represented by risk ratings (1–9), and to assign an estimated loan loss rate (*i.e.*, a percentage) for each loan grouping based on various factors. Resp'ts Ex. 8J, KPMGTO 5424. That loan loss rate then was multiplied against the total loan amounts within particular groupings and an allowance reserve computed on that basis. Large, non-homogeneous loans that were impaired would be

removed from the FAS 5 process and separately considered under FAS 114 and included within the ALLL. Resp'ts Ex. 8K, KPMGTO 5434-35. As Mr. Aesoph will testify, and as he explained in his investigative testimony, risk ratings drive the FAS 5 reserves and are therefore particularly sensitive and important to the development of the ALLL. The audit team devoted a great deal of time and effort in performing audit procedures regarding the FAS 5 process and results. The Division and Mr. Barron, however, have determined basically to ignore this component of the ALLL and to disregard the significance of the Risk Ratings' function.

FAS 114. The second component of the Bank's ALLL consisted of large, non-homogeneous loans that Management specifically identified for review under FAS 114. Segregated out from the rest of the portfolio, each of these loans was reviewed for impairment, meaning an assessment as to whether it was "probable" that TierOne would "be unable to collect all amounts due according to the contractual terms of the loan agreement." FAS 114 ¶ 8. No mechanical process exists for making this initial impairment determination; Management must instead exercise "judgment." *Id.* ¶ 8 ("This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment.").

If, in Management's judgment, a loan is impaired under FAS 114, the final step requires estimating the amount of impairment, if any. "Measuring impairment of a loan" also "requires judgment and estimates, and the eventual outcomes may differ from those estimates." *Id.* ¶ 11. Consistent with FAS 114, TierOne measured impairment by estimating the fair value of the underlying collateral. *Id.* ¶ 13. Management had "latitude to develop measurement methods that are practical in their circumstances." *Id.* ¶ 11. And because these impaired loans had "risk

characteristics that are unique to an individual borrower," Management had to estimate impairment "on a loan-by-loan basis." *Id.* ¶ 12. After factoring in selling costs and time to sell, and estimating the present value of the collateral, Management took the estimated shortfall between that adjusted collateral fair value and the outstanding loan balance as a charge-off or reserve (or some of both), depending on Management's judgment as to how certain the loss was. *Id.* ¶ 13; *see also* Resp'ts Ex. 8J, KPMGTO 5424.

It is error to conflate the separate steps of the FAS 114 analysis. If Management selects a loan for review under FAS 114, but ultimately deems it not to be impaired, there is no further step (*i.e.*, no need under FAS 114 to measure a shortfall in collateral value). This is true even where the remaining loan balance exceeds the collateral's value, so long as the borrower can pay "both the contractual interest payments and the contractual principal payments of a loan." FAS 114 ¶ 8. Accounting guidance allows a creditor to carry FAS 5 reserves on such loans, instead, and TierOne did so. *See* EITF D-80, Exhibit D-80A.

The Division's expert, John Barron, mistakenly fails to keep these steps separate when criticizing the decision not to discount appraised values for collateral securing two large loans. *See* Barron Report at 106–07. Because those two loans were *not impaired* under FAS 114—a determination that Mr. Barron does not challenge—any discussion of collateral discounts is irrelevant to the reserve TierOne booked for these loans. Worse yet, his analysis omits the fact that the reserves booked for these two loans under FAS 5 were larger than the Bank would have otherwise recorded for these loans had they been deemed impaired. *See* Johnigan Report at 13.

FAS 157. Another critical accounting standard applicable to TierOne's estimation process was FAS 157. Under FAS 157, fair value of TierOne's loan collateral was based on a hypothetical transaction that "maximize[s] the value of the asset." FAS 157 ¶¶ 7, 12. It required

Management to gather information on the amount the bank might receive in an "orderly transaction between market participants," which means here a sale of collateral where each market participant is "[k]nowledgeable . . . about the asset," "[a]ble to transact for the asset," and "[w]illing to transact." *Id.* ¶¶ 5, 7, 10. Of critical importance in this case, a "***forced transaction (for example, a forced liquidation or distress sale)***" is ***not*** an orderly transaction under FAS 157. *Id.* ¶ 7 (emphasis added). If "the seller is forced to accept the price in the transaction" due to "financial difficulty," the transaction simply does not represent fair value. *Id.* ¶ 17. TierOne applied this new and important guidance for the first time to its 2008 financial statements, yet one would never know from reading the OIP that FAS 157 was the governing standard defining fair value.

FAS 157 creates a "fair value hierarchy": three levels of "input" types used to make fair value estimates. "Level 1" inputs—the most precise—are defined as "quoted prices (unadjusted) in *active* markets for *identical* assets." *Id.* ¶ 24 (emphases added). One example is the value of shares of a publicly traded stock, for which the process of determining fair value is "simple and reliable." AU § 328.10.

At the other extreme is "Level 3." Management must operate here when "there is little, if any, market activity for the asset or liability at the measurement date." FAS 157 ¶ 30. In such a situation, valuation is made using "unobservable" inputs that "reflect the reporting entity's *own* assumptions about the assumptions market participants would use in pricing the asset." *Id.* ¶¶ 21, 30 (emphasis added). These Level 3 "assumptions about the assumptions" must be developed "based on the best information available in the circumstances," including "the reporting entity's own data." *Id.* Importantly, "the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions"; its duty is to adjust its assumptions using

"information [that] is reasonably available without undue cost and effort." *Id.* Needless to say, numerous judgment calls must be made when dealing with Level 3 inputs, and this was especially true in 2008 and early 2009.

Real estate, unlike public company stock, is particularly difficult to fair value under FAS 157. Even in the same geographic market, collateral for large loans had many distinguishing features affecting what a willing buyer might pay in an orderly transaction. TierOne disclosed its use of Level 3 inputs to its investors, indicating the level of judgment inherent in its estimate of impaired loan losses. Resp'ts Ex. 36, TierOne Corp., Annual Report (Form 10-K) (March 13, 2009), at 118, 120 ("TierOne 2008 10-K").

2. Auditing of Accounting Estimates and Fair Value Measurements.

Auditing Accounting Estimates. Estimating ALLL was Management's job. Mr. Aesoph's role was to audit both the estimate and TierOne's internal controls relevant to the process for arriving at it. The OIP notes this division of responsibility but fails to respect it. The Division suggests a duty to audit each individual FAS 114 determination for each individual loan. *See* OIP ¶¶ 61–63. But the auditors were "responsible for evaluating the reasonableness of accounting estimates made by [M]anagement in the context of the financial statement taken as a whole." AU § 342.04. This meant obtaining "sufficient competent evidential matter to provide reasonable assurance that" Management's total ALLL estimate was "reasonable in the circumstances," AU § 342.07, while "giv[ing] adequate attention to the propriety and accuracy of the data underlying material assumptions and estimates." SEC Staff Accounting Bulletin No. 102, *Background.* The team was "not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in [TierOne's] loan

portfolio." AICPA, Audit and Accounting Guide: Depository and Lending Institutions ("AAG-DEP") § 9.45 (2008).[6]

The auditing literature explicitly allowed Mr. Aesoph to fulfill his duty here by assessing Management's *process* for determining the ALLL. AU § 342.10 (allowing auditor to "[r]eview and test the process used by management to develop the estimate"). In applying "professional judgment" to "evaluate whether [TierOne's] method of measurement [was] appropriate in the circumstances," AU § 328.18, the auditors examined a large number of individual loans to understand and assess TierOne's process for estimating the ALLL, and to gather sufficient evidential material to determine whether the process reasonably considered the relevant factors.

Reasonable Assurance. In assessing the reasonableness of Management's estimate of ALLL, "the auditor is not an insurer and his or her report does not constitute a guarantee." AU § 230.13. He cannot test each separate accounting event that may have taken place over the course of the reporting period, nor can he predict the future. "The exercise of due professional care allows the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatement . . . . " AU § 230.10. "Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud." *Id.* Thus, "in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing." AU § 230.11.

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[6] *See also* AU § 328.32 ("Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves."); *Id.* § 328.38 ("[T]he auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management.").

Professional Judgment and Skepticism. To evaluate auditor performance at each stage of the audit is to assess how the auditor exercised professional judgment with inherently imperfect information. Professional judgment touches all aspects of the engagement.

- "[T]he areas to be tested and the nature, timing, and extent of the tests to be performed" are determined based on professional judgment. AU § 230.11.
- "[I]nterpreting the results of audit testing and evaluating audit evidence" requires judgment. *Id.*
- "[E]valuating the reasonableness of accounting estimates" depends upon judgment. *Id.*
- "The measure of the validity of [audit] evidence . . . lies in the judgment of the auditor." AU § 326.02.
- "The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment." AU § 326.22.

Auditors exercising good judgment will bring a proper dose of "professional skepticism" to their work: "an attitude that includes a questioning mind and a critical assessment of audit evidence." AU § 230.07. But skepticism does not mean unwarranted mistrust. "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." AU § 230.09.

IV.
THE DIVISION'S ALLEGATIONS REST ON FLAWED PREMISES

The Division's case against Messrs. Aesoph and Bennett rests on a distorted picture of the year-end 2008 audit and the professional standards on which it was based. Those standards, properly understood, required the auditors to obtain reasonable assurance about the relevant *financial statement assertion*—ALLL—in the context of the financial statements taken as a whole. *See* AU § 342.04; AS No. 5 ¶ 28 ("Relevant assertions are those *financial statement assertions* that have a reasonable possibility of containing a misstatement . . . .") (emphasis

added). "FAS 114 loans" was not an assertion in TierOne's year-end 2008 financial statements. Nor was the number of "current" or "stale" appraisals. *E.g.*, OIP ¶¶ 2–4. By fixating on narrow topics such as these, and then distorting their meaning and significance, the Division and its experts ignore the principles that Messrs. Aesoph and Bennett were bound to follow.

FAS 157 and "Stale Appraisals." One would never know from reading the OIP or the Division's expert reports that FAS 157 was a crucial, newly adopted provision of GAAP for the year-end 2008 audit. Nor would one know that it dictated how TierOne estimated the fair value of collateral securing its collateral-dependent impaired loans. Mr. Barron's report briefly mentions FAS 157 but then tosses it aside, never once acknowledging FAS 157's complex precept for hypothesizing an "orderly transaction" that "maximize[s] the value of the asset" using "unobservable inputs." *See* FAS 157 ¶¶ 7, 12, 30; Barron Report at 22–23. Professor Thakor, meanwhile, does not even *cite* FAS 157 in his 241-page report—and he is the Division's *valuation expert*.[7] The Division and its experts instead propose a new accounting requirement that contradicts FAS 157. Under this erroneous view: (1) if appraisals were "stale," then the auditors must have failed to test hypothesized controls for keeping appraisals "current"; and (2) those must have been key controls, because the Division (but no accounting literature) says current appraisals or a market-trend driven loan value discount were mandatory. OIP ¶¶ 3, 44.

Unlike the Division and its experts, Mr. Aesoph and his engagement team could not ignore FAS 157 when they evaluated the reasonableness of TierOne's impaired loan losses. FAS

[7] Indeed, Professor Thakor concedes that he does not even attempt to conduct a GAAP-based analysis of TierOne's FAS 114 accounting when he "recalculates the 'Required ALLL' at the *borrower* level" for 143 of TierOne's loans. Thakor Report ¶ 353 (emphasis in original); *see id.* ¶ 346 ("I do not express an opinion here on what TierOne's ALLL on any FAS 114 loan should have been on December 31, 2008."). Because of the serious flaws in Professor Thakor's analysis—including his complete disregard of FAS 157—Respondents have filed a joint motion to exclude both his testimony and his report from consideration at trial. *See* Respondent's *First* Joint Motion *in Limine* – To Exclude the Report and Testimony of Anjan V. Thakor (Aug. 29, 2013).

157 required them to consider *all* available evidence—"the best information available in the circumstances." FAS 157 ¶ 30. They could not rely exclusively on appraisals or market data that, in the midst of the financial crisis, did not represent the hallmark "orderly transactions" on which fair value must be based. *See* James Report ¶ 44. The complaints the Commission filed in its other cases (against TierOne Management) make this very point: "If there is no current appraisal, *all relevant and current information known at the time must be used.* This information includes: the most recent evidence of market declines, broker price opinions, recent comparable sales, internal determinations of value, current project status, and offers to purchase or sell." Langford Complaint ¶ 22 (emphasis added). In this proceeding, though, the Division all but ignores that requirement in the accounting guidance, just as it ignores the auditors' consideration of TierOne's financial statement disclosures that losses on its impaired loans were subject to nuanced FAS 157 judgments, based on "assumptions about assumptions." *See* TierOne 2008 10-K, at 118, 120; FAS 157 ¶¶ 21, 30.

Charge-Offs and the FAS 5 Component of the ALLL. The Division's allegations against Messrs. Aesoph and Bennett rest on an incomplete consideration of ALLL's component parts, obscuring the Bank's actual loan loss recognition at year-end 2008 and the breadth of the auditors' ALLL procedures.

First, by pretending that charge-offs did not occur, the Division and its experts severely distort the actual results of TierOne's FAS 114 accounting. The Division's audit expert, Mr. Barron, "implies a loan loss recognition by TierOne of *less than 9%* of the FAS 114 loan balances ($16.4 million divided by $186 million)." Johnigan Report at 7 (emphasis added); *see* Barron Report at 4. But Mr. Barron's figure completely ignores some $40 million in impaired loan losses that had been charged off—and therefore removed from the balance sheet—in 2008.

Resp'ts Ex. 8J, KPMGTO 5426–28; TierOne 2008 10-K, at 55. When both reserves and charge-offs are considered together, as they must be for a complete understanding of TierOne's recorded losses in the financial statements taken as a whole, total losses on loans the Bank deemed to be impaired were 22%. Not only did TierOne recognize a loss of more than *one-fifth* the value of all impaired FAS 114 loans, Johnigan Report at 7, in more erratic markets the Bank recognized even larger losses. In Nevada, for example, the amount was 30%. *Id.* When the Division's math is corrected, TierOne's loss numbers actually align closely with the third-party market data that Mr. Barron and Professor Thakor say the auditors "ignored": an 18–19% decline in national real estate prices, and a 30% decline in Nevada. Barron Report at 5, 27; Thakor Report ¶ 95. Instead of acting as a red flag that TierOne's estimates were unreasonable, this was additional evidence that the estimates were reasonable.

Second, the Division sidelines the largest component of TierOne's ALLL: its FAS 5 reserve. It accounted for more than 90% of TierOne's overall loan balance at year-end 2008. The significance of this component of the ALLL is lost on the Division, but it was not lost on the auditors. They performed extensive procedures to test TierOne's loss factors, its risk ratings for individual loans, the computerized systems the Bank used to track this data, and the controls TierOne implemented in 2008 to enhance its FAS 5 accounting. Mr. Aesoph himself prompted the Bank to compile a comprehensive 38-page memorandum to explain, on a market-by-market basis, how the Bank's overall ALLL methodology and resulting accounting comported with the Bank's prior loss history and current market trends. Resp'ts Ex. 8K. This document was in turn supported by a nearly 300-page tie-out analysis—which the auditors also reviewed—that included specific loan portfolio data as well as third-party market reports. Resp'ts Ex. 68. Again, the auditors' goal, consistent with professional standards, was to obtain reasonable assurance

about the financial statement item—the ALLL—and the controls over that item, in the context of the financial statements as a whole. By ignoring the vast majority of TierOne's ALLL—and the fact that TierOne's recognized losses were consistent with general market trends—the Division paints a distorted view of the audit team's procedures.

Purported Management Bias and OTS Capital Ratios. The Division and its audit expert also fault the auditors for allegedly going too easy on Management. Through the Division's distorted lens, Messrs. Aesoph and Bennett ignored various "red flags" that indicated Management bias. For example, the Division and its expert assert that the auditors disregarded the increased capital ratios mandated by the OTS, which might have tempted Management to "minimize additions to the ALLL." Barron Report at 19; OIP ¶¶ 32.a, 33. At the same time, the Division claims that when the Bank received new appraisals and incorporated them into its fair value estimates, this too should have been a "red flag" because, by the Division's flawed calculations, new appraisals resulted in write-downs that were *too big* (even in a highly volatile market). OIP ¶ 25.[8]

To the contrary, the auditors recognized precisely the risk presented by the increased capital ratios and enhanced their ALLL procedures accordingly. During the audit planning procedures, a team of KPMG forensic specialists led a discussion on potential sources of fraud, during which the audit team identified the bank's capitalization level as an industry-specific fraud consideration that could cause management to avoid booking needed loan loss reserves. Resp'ts Ex. 4B, KPMGTO 3896; *see also* Resp'ts Ex. 3E, KPMGTO 3679, 3689. The auditors

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[8] As explained below in section V.C., the declines in value that TierOne recognized when it took account of new appraisals were in fact far smaller than the numbers Mr. Barron suggests in his report. Indeed, the value declines that TierOne booked were consistent with overall market trends.

decided to treat the ALLL as a "high-risk" audit area and to intensify their audit procedures. Resp'ts Ex. 3E, KPMGTO 3679, 3689; *see also* Resp'ts Ex. 3F, KPMGTO 3699.

Just as the Division and its auditing expert ignore the attention the auditors paid to risks of Management bias, they also ignore evidence giving the auditors adequate assurance that bias had not, in fact, affected the accounting. Apart from the Division's bad math, in which it ignores charge-offs, the Division also ignores TierOne's *FAS 5* reserves on 10 loans the Bank had deemed not to be impaired under FAS 114's first step. The $6.5 million in FAS 5 reserves *exceeded* "the FAS 114 loss reserves that would have been recorded if the loans were deemed impaired with their existing collateral values." Johnigan Report at 13. In spite of the increased capital ratios, TierOne's judgment for these loans led to the recognition of additional losses. The Division's expert again ignores this piece of information, erroneously assuming that merely because these 10 loans were *evaluated* under FAS 114, they must have been *deemed impaired* at the end of step one. *See* Barron Report at 107–11.

The list of evidence contrary to Management bias goes on. For example:

- The Bank booked $6 million in loan reserves after its Internal Audit Department concluded that Valley Heights, a large loan originated in Nevada, should be deemed impaired. Resp'ts Ex. 8I, KPMGTO 5414. This was a direct hit to capital right at year-end.

- New appraisals for the HDB and Rodney Kush loans were *higher* than the valuations TierOne was using, proving that the Bank's previous loss estimates were *conservative*. Johnigan Report at 13.

- TierOne's treatment of another loan, Rising Sun, provided strong evidence of Management's ability to make reasonable valuation estimates. In the second quarter of 2008, a new appraisal for the loan's collateral suggested a 58% decline in value compared to an earlier appraisal. In the previous quarter, however, TierOne had already discounted the collateral by 57%—remarkably close to what the updated appraisal suggested. Johnigan Report at 8.

- After Mr. Aesoph identified a triggering event that suggested an impairment of the Bank's $42 million in goodwill, TierOne wrote down the *entire*

balance, a huge hit to the balance sheet. Resp'ts Ex. 26, KPMGTO 38585; Resp'ts Ex. 13, KPMGTO 486.

* * *

The Division seeks to tell a simple story with its allegations of "stale appraisals" and "red flags." But a rich body of facts and accounting guidance shows the Division's story to be what it is—an oversimplification and consequent mischaracterization of the audit. Mr. Aesoph and his team did not limit themselves to one aspect of TierOne's FAS 114 estimation process, nor did they consider only the subset of evidence on which the Division and its experts choose to rely. What mattered to Mr. Aesoph, under professional auditing standards, was whether evidence from the entire audit gave reasonable assurance that (1) TierOne's internal controls were free of material weaknesses and (2) TierOne was reasonably estimating and accounting for loan losses in the context of the financial statements taken as a whole. Under Rule 102(e), it is this perspective—complete in its facts and based on an accurate view of GAAP—that must govern this matter.

V. THE YEAR-END 2008 AUDIT COMPLIED WITH APPLICABLE AUDITING STANDARDS

A. The planning and performance of the 2008 audit demonstrated due professional care, including proper consideration of the evolving market conditions and the regulatory actions by the Office of Thrift Supervision.

Unlike the Division, Mr. Aesoph and his team were not at liberty to invent new accounting guidance. It would have made their audit much simpler had they disregarded PCAOB standards and the accounting guidance and instead taken a one-size-fits-all approach, including demanding TierOne use "current" appraisals and take haircuts on older appraisals based on market-wide indices of sales price trends. This is the simplistic approach the Division's valuation expert takes. Thakor Report ¶ 346 ("I simply calculate how TierOne's calculated 'Required

ALLL' would have changed had the publicly available market data been used to discount appraisals."). The auditors, however, were obligated to apply professional standards; they were required to exercise "due professional care" to meet the objective of obtaining "reasonable assurance" about TierOne's financial statements and its controls over financial reporting. AU § 230.10; AS No. 5 ¶ 3. And they did just that.

Risk Assessment. Consistent with the concept of due professional care, Mr. Aesoph and his team paid appropriate attention to the ALLL as a whole in the unique circumstances presented by the financial crisis. The team performed a Client Risk Assessment of TierOne, recognizing the significance of "the restrictions placed on the Company by the OTS" and "the economic downturn in the banking industry driven by delinquencies in the housing and real estate markets." Resp'ts Ex. 3E, KPMGTO 3689; Resp'ts Ex. 3F, KPMGTO 3699. The auditors noted that these caused "increased pressure to improve financial performance." Resp'ts Ex. 3F, KPMGTO 3699. These client-specific risks were also informed by risks inherent in the ALLL, which the team noted was "subject to judgment and require[d] specific knowledge and competencies." Resp'ts Ex. 3E, KPMGTO 3679. Combining the client-specific and inherent risks, the team "elected to revise [its] assessment [of ALLL's risk] to high." *Id.* This meant that the auditors would exercise "a heightened sense of awareness regarding loan valuation and credit risk" and "modif[y its] audit approach with respect to loan valuation given the current economic trends and continuing deterioration in TierOne's loan portfolio as well as the restrictions placed on the Company by the OTS." Resp'ts Ex. 3E, KPMGTO 3689.

Focus on Loans and Loan Files. This risk assessment led the auditors to pay particularly close attention to TierOne's loans. The auditors examined the Bank's extensive loan files in various contexts, including as part of both their detailed review of forty individual loans and their

extensive FAS 114 procedures. The Bank's loan files—which contained loan-specific information such as credit histories, appraisals, and interim and annual credit reviews—provided evidence to the auditors that the Bank's risk ratings and collateral valuations were adequately supported by the appropriate kinds of information. Resp'ts Ex. 8B, KPMGTO 5276–77; Resp'ts Ex. 8M, KPMGTO 5482. Mr. Aesoph and his team also reviewed *every one* of the FAS 114 templates the Bank had prepared and selected a sample for testing. Resp'ts Ex. 8M, KPMGTO 5482–548.

Consultation of Experts. Mr. Aesoph knew when to enlist assistance from subject matter experts. The audit team engaged Ms. Washek, the FRM specialist, to conduct loan reviews throughout 2008. In addition to focusing on the risk rating process, a process crucial to appropriately grouping loans for evaluation under FAS 5 as well as identification of impaired loans, Ms. Washek also assessed, at Mr. Aesoph's request, the Bank's FAS 114 methodology. Resp'ts Ex. 8D, KPMGTO 5284. By adding Ms. Washek to his audit team, Mr. Aesoph surpassed the requirements of professional standards and internal KPMG guidance. This move further evidenced Mr. Aesoph's recognition of risk with respect to the ALLL, in direct reaction to the changing financial landscape, including "the significant amount of credit losses experienced by TierOne during 2007 and 2008." Resp'ts Ex. 3E, KPMGTO 3657.

Mr. Aesoph brought in other experts too. Recognizing the significance of the OTS Report of Examination, he had the two Financial Regulatory Specialists, Hugh Kelly and Craig Stirnweis, analyze the practical impact of the OTS's regulatory actions. Resp'ts Ex. 15E, KPMGTO 1491–95; Resp'ts Ex. 3C, KPMGTO 3507. The engagement team also consulted economic valuation specialists, who helped in assessing TierOne's ultimate decision to write off the entirety of its $42 million in goodwill. *See supra* at IV; Resp'ts Ex. 26, KPMGTO 38585;

Resp'ts Ex. 13, KPMGTO 486. And forensics specialists helped assess fraud risks relevant to the audit and develop fraud-identification strategies. *See* Resp'ts Ex. 4B, KPMGTO 3896.

Finally, Mr. Aesoph consulted two highly experienced senior audit partners, David Butler and Terence Kenney, on every significant issue that arose—including the events that led to KPMG's ultimate resignation and withdrawal of its 2008 audit opinion. Mr. Butler, KPMG's Western Regional Professional Practice Partner who covered the firm's entire western presence, was very familiar with TierOne after serving as the SEC Concurring Review Partner on the engagement from 2002 until 2006. Mr. Kenney, the incumbent SEC Concurring Review Partner, was equally valuable. As the Audit Practice Leader for the Financial Services Practice of KPMG's Chicago office, he brought to the table 25 years of experience auditing financial institutions.[9]

Consideration of Regulatory Developments. The OTS's October 2008 Report of Examination concluded that TierOne's condition had materially deteriorated in the year and a half since the previous OTS report. The Report cited such things as "[s]ubstantial levels of risk and problem assets" and "concentrations [of assets] in weak markets." Resp'ts Ex. 15, KPMGTO 1377–78. OTS entered into a Supervisory Agreement with the Bank to remediate these problems through increased capital ratios, a strategic plan, and other mandates. Resp'ts Ex. 15, KPMGTO 1454–72; Resp'ts Ex. 1N.

The auditors monitored the OTS's expressed concerns early in its examination, in the first and second quarters of 2008, and accordingly enhanced their quarterly review procedures to include detailed loan reviews and substantive testing of select FAS 114 loans. The auditors were

[9] Mr. Kenney would very much like to appear at the hearing on this matter to express his high regard for Respondents and the work they performed for TierOne. But because he is gravely ill, we ask the Court to receive in evidence his written declaration. The Division had ample opportunity to question Mr. Kenney and has designated his entire testimony in this investigation as an exhibit.

conducting their third-quarter review procedures when the Report was ultimately issued, and they took prompt action to address it. Mr. Aesoph immediately held an hour-long meeting with TierOne CEO Gilbert Lundstrom. The following week, Mr. Aesoph followed up with the Audit Committee to hear the results of a meeting between the OTS and the TierOne Board of Directors. He also had Ms. Washek review several of the loans referenced in the OTS Report, and he asked Mr. Bennett to prepare a detailed analysis of the Report and independently assess its critical findings. Resp'ts Ex. 1J, KPMGTO 2565–71. That analysis considered, for example, that although the OTS identified a "deficiency" in TierOne's ALLL as of March 31, 2008, Resp'ts Ex. 15, KPMGTO 1390, the regulator ultimately concluded that the Bank's reserves as of the second quarter were "appropriate" and that the additional loss provisions TierOne booked "addressed [the OTS's] concerns," *id.*, KPGMTO 1430. *See* Resp'ts Ex. 1J, KPMGTO 2566, 2569. There was good reason for this conclusion: the OTS identified its ALLL deficiency "based on *new or updated information*." Resp'ts Ex. 1J, KPMGTO 2569 (emphasis added). It found TierOne's ALLL "appropriate" because the Bank recognized losses as they occurred. The OIP ignores this fact, never once mentioning that the OTS ultimately agreed with TierOne's ALLL. OIP ¶¶ 22, 77, 83.

When Mr. Aesoph asked Messrs. Kelly and Stirnweis (the Regulatory Specialists) for their formal assessment of the OTS Report, they concluded that while OTS was harshly critical of the Bank, it nonetheless chose supervisory actions of "limited severity." Resp'ts Ex. 15E, KPMGTO 1493. A Supervisory Agreement, rather than a Cease and Desist Order, reflected "confidence that management and the board is willing and able to address the conditions" at the Bank. *Id.*

The audit team further reviewed the Bank's submissions to the OTS and obtained Regulatory Issues Tracking Reports from TierOne's Internal Audit Department, which documented compliance with the Supervisory Agreement. Resp'ts Ex. 3C, KPMGTO 3507; Resp'ts Ex. 15D, KPMGTO 1452. Not stopping there, the auditors went directly to the OTS for confirmation. Douglas Pittman, an OTS Field Manager who monitored TierOne for fourteen years, informed the auditors that not only was TierOne complying with the requirements of the Supervisory Agreement but "the overall relationship between the OTS and the Company has been positive since the [Report] and [Supervisory Agreement]." Resp'ts Ex. 3C, KPMGTO 3507–08; Resp'ts Ex. 1K, KPMGTO 2573. According to Pittman, the Bank was "working diligently to clear the issues noted by the OTS." Resp'ts Ex. 1K, KPMGTO 2573.

B. The internal controls audit met professional standards by appropriately testing the overall FAS 114 process and using loan-specific substantive procedures to support the internal controls opinion.

1. The auditors' control procedures were based on GAAP, not on a fictional prohibition against "stale appraisals."

Contrary to the Division's allegations, no "magic bullet" control existed for the financial reporting related to TierOne's FAS 114 loans. FAS 114 and FAS 157 instead require an individualized analysis of each loan—accounting for the uniqueness of each loan's collateral—to arrive at a loss estimate. The auditors therefore designed their procedures to understand and test the kinds of controls relevant to the entirety of the loan-by-loan estimation process. Specifically, they tested controls addressing (1) identification of impaired loans; (2) reliability of inputs TierOne used in determining fair value estimates; (3) whether appropriate personnel estimated reserves for each loan on an individual basis; and (4) whether upper-level management was sufficiently monitoring the overall ALLL estimate, including its FAS 114 component. Through these key controls, the team tracked each step of the FAS 114 accounting process.

The Division ignores this comprehensive controls framework, instead inventing a new control that it custom-designed to concoct its allegation of "stale" appraisals. *See* OIP ¶ 44. To read Mr. Barron's report, one would expect support in the literature for requiring a control specific to "management's use of stale appraisals." Barron Report at 39, 41, 43, 47, 49. Mr. Barron asserts that this one-size-fits-all control would avoid appraisals more than 6 months old. *Id.* at 4 n.5 (using his own invented definition of "stale" appraisals), 41. The source of this control, though, is nothing more than reverse engineering: because the Division believes, in hindsight, that TierOne should have obtained "current" appraisals, it also believes the Bank needed a control for "stale" appraisals.

This approach is nothing more than rulemaking by enforcement action. GAAP contains no requirement as to when appraisals are deemed current and when they should be deemed "stale." Indeed, the guidance is clear that each loan and its circumstances are to be evaluated on a loan-by-loan basis. The requirement, under GAAP, to exercise judgment when making an estimate based on imperfect information is antithetical to a control where one data point, such as "stale appraisals," is the key. And whatever the value of appraisals in stable markets, it would have been especially misguided to rely solely on them in the second half of 2008 when appraisals reflected forced sales values, contrary to FAS 157. *See* James Report ¶ 44. By instead testing multiple controls covering TierOne's entire FAS 114 process, combined with additional substantive procedures, the auditors exercised proper judgment.

2. Because Mr. Aesoph's team conducted an integrated audit, their controls and substantive procedures must be considered as parts of a whole that together supported the auditors' overall conclusion as to each audit objective.

Consistent with PCAOB Auditing Standard No. 5 ("AS No. 5"), the year-end 2008 audit was integrated: Mr. Aesoph and his audit team designed their procedures to perform

simultaneously (1) a proper audit of TierOne's consolidated financial statements and (2) a proper audit of TierOne's internal control over financial reporting. *See* AS No. 5 ¶¶ 6–7; *see also* Resp'ts Ex. 8A. This meant that the internal controls audit supported and informed the financial statements audit, and vice versa. *See* AS No. 5 ¶¶ 8, B4, B5.

The audit team's extensive loan reviews are illustrative. These reviews let the auditors "place reliance on the data in the ALLL" while also providing assurance as to TierOne's loan evaluation process. Resp'ts Ex. 8B, KPMGTO 5277. Likewise, the auditors' extensive reviews of TierOne's FAS 114 templates supported both their financial statements and internal controls opinions. The Division ignores the interrelationship between these two audit objectives and the fact that Mr. Aesoph's ultimate conclusions were based on the full extent of the year-end 2008 audit work.

3. The auditors developed an understanding of the Bank's process, bottom-to-top, for accounting for impaired loans.

Starting with their walkthrough procedures—a key step in an internal control audit, *see* AS No. 5 ¶¶ 37–38—Mr. Aesoph and his audit team developed a comprehensive understanding of TierOne's extensive FAS 114 process. First, the Bank's loan accounting systems generated reports identifying past-due loans. Resp'ts Ex. 2A, KPMGTO 3025; Resp'ts Ex. 7B, KPMGTO 5017–18. Next, TierOne's Credit Department prepared loan analyses and assigned risk ratings to each identified loan. Based on this information, the Chief Credit Officer prepared a monthly Operating Performance and Grading Summary Report that included loans assigned a risk rating of "special mention" or worse, as well as loans rated "pass" that exhibited "negative conditions" (for example, delinquent loan payments or low occupancy in a residential development). Resp'ts Ex. 7B, KPMGTO 5017–18.

If a loan was considered for impairment status (including those ultimately deemed to be impaired), credit administration personnel used all information reasonably available to prepare a loan-specific FAS 114 template for valuing the loan's collateral and estimating probable losses. Resp'ts Ex. 2A, KPMGTO 3027. The OTS's 2008 Report found TierOne's template to be an "appropriate" method "to measure quarterly impairment loss on impaired loans pursuant to SFAS No. 114." Resp'ts Ex. 1M, KPMGTO 2616. The OTS further concluded that this template "greatly enhanced" "the adequacy of [TierOne's] ALLL." Resp'ts Ex. 151, OTS-TIERONE-EF-00045064-2. Backed by the analysis found in these FAS 114 templates, TierOne booked each impaired loan's charge-offs and reserves and booked FAS 5 reserves for those deemed not to be impaired.

TierOne's Asset Classification Committee ("ACC"), played a key role in the Bank's FAS 114 process, and the auditors consequently tested the ACC's function. Resp'ts Ex. 2A, KPMGTO 3027; Resp'ts Exs. 7D, 7E. The members of the ACC—high-level personnel with critical roles in the management of the Bank's loan portfolio—included [redacted] (CEO), [redacted] (COO), [redacted] (CFO), [redacted] (Controller), [redacted] (Chief Lending Officer), and [redacted] (Chief Credit Officer). The ACC was "responsible for . . . the early identification and prompt classification of potential problem assets [and] . . . for ensuring complete and accurate reserve adequacy assessment in support of the Bank's ALLL Policy." Resp'ts Ex. 143, KPMGTO-E-00106114. In performing this function, the ACC reviewed various loan-specific credit reports, including a "narrative and statistical discussion of . . . [r]ecommendations for non-accrual and specific reserves." *Id.* at 106391; Resp'ts Ex. 2A, KPMGTO 3027. The ACC also reviewed and approved the ALLL calculation at

each quarter, including separate, individualized reserves and charge-offs for loans evaluated under FAS 114. Resp'ts Ex. 7D, KPMGTO 5066.

4. The auditors tested key controls over TierOne's process of identifying and evaluating impaired loans, and then tested the outcome of FAS 114 evaluations through substantive audit procedures.

The auditors' bottom-up understanding of TierOne's FAS 114 valuation process informed their strategy for testing internal controls. Contrary to the Division's allegations, the auditors selected tests that addressed the key aspects of TierOne's FAS 114 process, including identification of impaired loans, the Bank's loan-specific evaluations, and, ultimately, the overall ALLL estimate. Ms. Johnigan's comprehensive expert report details the auditors' procedures for each of these key controls, including the auditors' tests of the key ACC control. Johnigan Report at 41–48.

FAS 114 requires a highly judgmental, loan-by-loan estimation process, not one amenable to a one-size-fits-all test of controls. Mr. Barron fails to explain the utility of a "no-older-than-6-months" appraisals control, *see* Barron Report at 43–44, when FAS 114 and FAS 157 both require *individual* attention to each separate FAS 114 loan. Ms. Johnigan explains in her report why no one particular control could adequately address FAS 114 valuation: TierOne's FAS 114 accounting relied, by necessity, on individualized judgments about unique pieces of real estate. "Controls designed to ensure uniformity in application are not, by definition, designed to address a series of one by one judgments." Johnigan Report at 38. Thus, Mr. Aesoph and his team tested the *process* for identifying impaired loans and the *method* for determining how much each loan was impaired. Then, in their substantive procedures, they sample-tested the *output* of that process—TierOne's loan-specific loss estimates. In combination,

these controls-based and substantive procedures resulted in reasonable assurance that TierOne's FAS 114 controls were effective and the ALLL as a whole was not materially misstated.

5. The auditors appropriately considered TierOne's lending policy and the Bank's use of appraisals as single data points relevant to fair value.

The Division also faults Mr. Aesoph for failing to test TierOne's compliance with its lending policy. The auditors supposedly "failed to identify any control to ensure compliance with" a business practice of obtaining new appraisals "if market deterioration indicated that the collateral may no longer fully protect the loan." OIP ¶¶ 57, 58; *see also* Barron Report at 51–53.

The Division and its expert misstate the lending policy and ignore the attention the auditors paid to TierOne's practice of ordering appraisals. The auditors obtained evidence that the Bank assessed appraisals for its FAS 114 loans individually and applied discounts, as appropriate, to estimate the fair value of each loan's collateral. These audit procedures provided reasonable assurance that TierOne did precisely what accounting guidance required—make an informed estimate using the best available information. *See* FAS 157 ¶ 30.

TierOne's Lending Policy Guide reflected this accounting guidance. Rather than impose an unyielding requirement of current appraisals in every loan file, the policy required loans to be "supported by current appraisals *or evaluations*" and suggested that "[c]hanges in market or property conditions . . . could justify an updated *evaluation*." Resp'ts Ex. 143, KPMGTO-E-106163–64 (emphasis added). The auditors, in testing TierOne's appraisal review control, confirmed that TierOne followed this practice. In the work papers, the auditors noted that "appraisals are not current in all cases but management *estimates and documents their rationale supporting valuation in these cases*. As part of our loan review, we noted no exceptions regarding management's estimat[ion] process and thus this is not a deficiency." Respt's Ex. 7G, KPMGTO 5093 (emphasis added).

C. The substantive audit of TierOne's FAS 114 accounting satisfied the audit objective of obtaining reasonable assurance about the loan loss estimate in the context of the financial statements as a whole.

1. A proper understanding of TierOne's FAS 114 templates demonstrates that the Bank appeared to reasonably estimate fair value using older appraisals.

The Division's criticism of the auditors' substantive procedures is based on the notion that the auditors should have demanded that TierOne obtain newer appraisals. This criticism misses the point that the auditor's job is to opine, not to take an active role in Management's duties. When the auditors did what auditors really do, they found sufficient evidential matter to conclude that the Bank's valuation process was reasonable and reliable.

When Management estimated ALLL, one step was to determine the fair value for each impaired loan's collateral. In assessing the reasonableness of the resulting ALLL in the context of the financial statements taken as a whole, Mr. Aesoph's team did not opine on whether the loss estimates for individual loans were "correct." "[T]he auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management." *See* AU § 328.38; *see also* AAG-DEP § 9.45 (an auditor is "not responsible for estimating the amount of the allowance or ascertaining the collectability of each, or any, specific loan"). Ms. Johnigan correctly observes that KPMG was not hired to conduct a "special valuation engagement," Johnigan Report at 52, nor is the currency of appraisals a financial statement assertion that Mr. Aesoph and his team were required to audit. It is irrelevant whether an auditor, standing in Management's shoes, might have ordered additional appraisals. The Division's argument reduces to a *per se* rule that the auditors could not issue a clean audit report if the Bank did not order additional appraisals or discount existing ones using only market-trend data. The auditing literature offers no support for that extreme proposition.

The Division does not just misconstrue the literature, however. It also garbles the facts. The Division's audit expert, Mr. Barron, asserts that the new appraisals TierOne obtained in 2008 led to an "average net decline in value [of] approximately 17% from the prior quarter." Barron Report at 76. The size of the drop matters, says the Division, because "[t]he magnitude of the[se] quarter-to-quarter declines could not be explained by market conditions alone." OIP ¶ 25. Hence, the argument goes, the auditors should have suspected that the ALLL was flawed.

But the average decline from the prior quarter was not 17%; it was less than 10%. Mr. Barron and the Division got the math wrong because they fail to compare the property's value, as stated in the new appraisal, to the property's value, as *actually estimated by TierOne* in the previous quarter. Instead, Mr. Barron compares new appraisal numbers to a line on the FAS 114 templates that does not include all charge-offs and reserves TierOne applied to the particular loan. If Mr. Barron had compared new appraisal values to the *correct* number—the value TierOne had previously estimated—he would have found that the overall quarterly declines in fair value estimates was below 10%. Johnigan Report at 9. And his computation of average quarterly declines for Nevada would be even lower: 8.6%. *Id.* This tracks very well with the "7% to 8%" decline that Mr. Barron describes as "normal" and "expected" at that time in that market. Barron Report at 78. The Division's red flag was actually evidential matter confirming the apparent soundness of TierOne's process for estimating fair values.

2. The auditors' tests over the FAS 114 ALLL focused on the individualized assumptions TierOne used to value real estate collateral and calculate impaired reserves.

The substantive FAS 114 audit procedures were well informed by an understanding of the sources of weakness in TierOne's loan portfolio. The team noted that "Nevada, Florida, and other states . . . have been significantly impacted by depressed real estate values and

deteriorating market conditions." Resp'ts Ex. 8J, KPMGTO 5430. With this risk-based paradigm in mind, the team obtained a broad understanding of TierOne's overall FAS 114 loss estimate by examining trends and summary data. They "[r]eview[ed] the listings of impaired loans and nonperforming loans to determine the level of reserves estimated by management" and obtained evidence that individual loans were "appropriately considered in conjunction with the ALLL calculation." *Id.* They also "[i]nquire[d] of management regarding any significant trends in delinquencies, changes in loan assessments and ratings, and credit issues since the prior quarter and year." *Id.* These trends supported the auditors' conclusion that "there was no indication of bias on management's part in developing their estimates." Resp'ts Ex. 3C, KPMGTO 3482.

There was much more to the auditors' analysis, though. The centerpiece of their procedures was a particularized analysis of individual FAS 114 loans. The audit team obtained the templates for every loan TierOne had individually evaluated under FAS 114. Resp'ts Ex. 8M; *see also* Resp'ts Ex. 8A, KPMGTO 5192. The auditors organized their review of the FAS 114 templates by geographic market to understand how TierOne Management had considered unique conditions in the region of each loan's collateral. In doing so, the auditors used third-party market analyses to determine whether loss estimates for each geographic region fell within a reasonable range. For a sample of these FAS 114 loans, the team obtained and reviewed original third-party appraisals of the real estate securing the loans. For that sample, the engagement team obtained audit evidence in order to evaluate Management's estimate of the fair value of the collateral securing the loans.

It is difficult, in light of these substantial procedures, to understand why the Division and its retained expert accuse the audit team of relying on "uncorroborated management

representations" and failing to adequately document TierOne's specific property assumptions. OIP ¶¶ 76, 78; *see also* Barron Report at 71–73. Neither accusation is accurate.

The auditors did not simply take Management at its word. Their FAS 114 procedures included an examination of "appraisal values and other information"; this evidence showed that TierOne's "assumptions were appropriately adjusted for any new information." [Resp'ts Ex. 8M, KPMGTO 5482. When the Division alleges that the auditors' property-specific information came from mere "inquiries" of Management, OIP ¶ 76, it neglects to explain what these inquiries actually entailed: meetings with knowledgeable personnel, onsite, where the Bank's comprehensive loan files were close at hand. When "inquiring" of Management, the audit team checked the information they received against the loan files; those loan files included third-party documentation including broker price opinions, debtor-supplied documents, and the appraisals themselves. In addition to these procedures, the auditors "leveraged" the loan file reviews that they, their FRM Specialist, and TierOne's Internal Audit Department had performed throughout 2008 "to get comfortable that the reserves calculated in the FAS 114's were accurate." Resp'ts Ex. 8M, KPMGTO 5482. This was not an "audit by conversation." The auditors evaluated all information reasonably available that bore on the Bank's FAS 114 estimates. *See* FAS 157 ¶ 30.

The Division's accusations regarding the sufficiency of audit documentation also fall flat. TierOne's FAS 114 templates included numerous pieces of loan-specific information that informed the Bank's allowance estimates, and the audit team annotated those templates with additional information they found relevant to their audit conclusions. The auditors were obligated to document "sufficient information 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." PCAOB Auditing

Standard No. 3, ¶ 6. Ms. Johnigan, a former audit partner and Co-Chair of her former firm's Financial Services group, is particularly experienced with regard to the banking industry. Her report cites work paper after work paper explaining the audit plan, the procedures performed, the evidence obtained, the auditors' evaluation of the evidence, and the conclusions reached. Her report therefore validates that the documentation of the year-end 2008 TierOne audit satisfied professional standards.

3. The auditors did not assume that appraisals less than a year old were "current"; they obtained evidence that TierOne considered every piece of collateral individually, regardless of appraisal dates.

The Division claims that "Aesoph and Bennett relied on an unsupported—and unsupportable—assumption that appraisals less than a year old were 'current,' without regard to the property's location or stage of development, and that market conditions had not materially deteriorated throughout the year." OIP ¶ 74. The Division's proffered audit expert parrots this allegation, claiming that the auditors employed a "blanket twelve-month definition of a stale appraisal." Barron Report at 92 (apparently ignoring the fact that he is employing a "blanket" six-month definition of a stale appraisal).

Given the loan-by-loan analysis required under FAS 114, there is no room for a rule requiring each loan file to contain a particular document from a particular time period. FAS 114 and FAS 157 require a judgment based on consideration of all reasonably available information. The auditors complied by evaluating the reasonableness of TierOne's FAS 114 estimates in light of all such information, whether or not the loan file included a current appraisal in its mix of data. Moreover, because TierOne's riskiest markets were dominated by forced sales in the second half of 2008, new appraisals did not measure fair value under FAS 157. James Report

¶¶ 34–37. The auditors had no power or duty to insist on any particular type of evidence, especially one with limited utility.

Through their loan-by-loan reviews of TierOne's FAS 114 templates, Mr. Aesoph and the audit team obtained evidence that the Bank had considered each loan individually. Relevant to this analysis were real estate appraisals and the dates they were prepared. But that was only one part of a larger picture; the auditors also evaluated TierOne's use of other property-specific information bearing on collateral value. For example, they considered

- whether appraisals reflected "as is" values or assumed completion of construction, Resp'ts Ex. 14H, KPMGTO 874, 897;
- appraisals for other properties and whether the other appraisals showed consistent valuation in the same market, Resp'ts Ex. 13N, KPMGTO 428;
- the relative utility of individual appraisals and whether they reflected forced sales that are irrelevant under FAS 157, Resp'ts Ex. 8K, KPMGTO 5458;
- individual circumstances that might impede timely foreclosure and sale of the property, Resp'ts Ex. 14H, KPMGTO 872;
- "recent real estate trends and values" in the relevant market, Resp'ts Ex. 13E, KPMGTO 387, and recent sales prices for individual housing units, Resp'ts Ex. 8M, KPMGTO 5543; and
- selling costs and the present value of collateral proceeds, based on expected months-to-sale. Resp'ts Ex. 8M, KPMGTO 5505.

The Division assumes it was simple to value large, unique real estate assets in 2008's turbulent markets. In reality, every data point available in 2008—including appraisals—was affected by the uncertainty under which even the best-educated market participants labored. James Report ¶ 21 ("[R]educed sales volume and an increase in the proportion of distressed sales increased the difficulty of estimating the fair value of properties.").

Fully aware that forced sales were increasingly prevalent, the auditors documented TierOne's conclusion that new appraisals became less useful among the many potential data points:

> 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. Trying to estimate how much an aggressive seller would be willing to discount future sales prices to accelerate liquidation process is very difficult. The Bank tries to estimate collateral value declines in real estate by discounting appraised values, which are older than six months. The percentage of that discount is based on facts and circumstances specific to the area where the collateral is located.

Resp'ts Ex. 8K, KPMGTO 5458. Banks like TierOne—as well as their auditors—had to make the best of the imperfect information that was available at the time. Contrary to the Division's allegations, Mr. Aesoph and his audit team did not make uniform assumptions about appraisals based on their age. They evaluated each FAS 114 loan individually, as they were supposed to.

4. The fluctuation in TierOne's unallocated ALLL during 2008 properly reflected the need for provisions in specific markets.

Finally, the Division calls the reduction in TierOne's unallocated ALLL from mid-2008 to year-end a "red flag." OIP ¶ 28. Unallocated ALLL—only 6% of the overall ALLL at year-end 2008—reserved for estimated losses already incurred in the portfolio but for which there was insufficient information to allocate to specific loans. When it became clearer which loans had losses, TierOne was able to reduce the unallocated ALLL accordingly. This change was therefore the opposite of a "red flag." It showed that TierOne prudently recognized losses in locations such as Nevada early in the year, even when not yet assignable to specific loans, and then, upon obtaining loan-specific information later in the year that led to identification of newly-impaired loans and more current risk rating classifications, the Bank allocated the losses to specific loans and specific groupings. Johnigan Report at 75.

The Division's allegations about the unallocated ALLL, like its other assertions, are based on a selective reading of the facts, tainted by hindsight. Viewed objectively and as a whole, the auditors' procedures provided reasonable assurance that the *entire* ALLL—including its FAS 5, FAS 114, and unallocated components—was not materially misstated.

VI.
APPRAISALS TIERONE RECEIVED IN 2009 DID NOT TRIGGER AU § 561

The Division alleges that Mr. Aesoph violated AU § 561 by not conducting an investigation regarding additional losses TierOne recorded on particular loans[10] in the first and second quarters of 2009, based on newly received appraisals. OIP ¶ 86, n.6. But these newly received appraisals simply did not trigger AU § 561. Mr. Aesoph understood his AU § 561 duties. In fact, when new information coming to light *did* trigger AU § 561, Mr. Aesoph diligently investigated and, as a result, caused KPMG to withdraw its opinion for the 2008 audit and resign as TierOne's auditor. *See* Section VII *infra*. The Division's quarrel with the *timing* of Mr. Aesoph's AU § 561 investigation is unwarranted.

AU § 561 has a narrow focus. If, "subsequent to the date of the report upon audited financial statements," an auditor "becomes aware that facts *may have existed* at that date which *might have affected the report* had he or she been aware of such facts" when he issued the report, he should investigate. AU § 561.01 (emphasis added). The two triggering criteria—facts that "may have existed" on the date of the audit report and that "might have affected" that report—require an auditor to apply judgment in determining whether new facts require special retroactive attention. As Ms. Johnigan explains, this amounted to "a relatively high threshold" in light of

[10] In the OIP, the Division names six loans that it claims should have been subjected to AU § 561 procedures. Mr. Barron, however, mentions only "five specific lending relationships" in discussing the Division's AU § 561-related allegations. *See* Barron Report at 96. Whatever the number, none of these loans triggered AU § 561.

TierOne's $93 million pre-tax loss and $84 million loan loss provision at year-end 2008. Johnigan Report at 80. The Division's allegations fall far short of this threshold.

The appraisals that resulted in the additional 2009 losses simply did not rise to the level of information that required further investigation. Now that Management's fraud has come to light, it is tempting to play the game of "what if someone had asked *this particular* question." But performing that hindsight-based exercise with these additional appraisals would be wrong. As documented in the auditors' consideration of increased provisions, the newly-received appraisals resulted in additional provision of approximately $5 million in the first quarter of 2009. This amount was chiefly the result of losses on three loans—MME, Celebrate 50, and Ashley Turner—each of which the auditors had previously assessed. The auditors observed TierOne recognizing significant losses on these loans throughout 2008. *See* Johnigan Report at 96–97, 97–100, 120–21. Indeed, those 2008 losses on these three loans were comparable in magnitude—and in some quarters *greater than*—the losses TierOne booked as a result of the newly received appraisals in 2009. *Id.* Given provisions totaling $80 million over the course of 2008, $5 million in provisions for a handful of impaired loans in troubled markets does not jump out as unusually or opportunistically timed.

Moreover, the Division's argument assumes that the auditors would have somehow seen only the appraisals that showed a *drop* in appraised value. In hand-picking six loan relationships, the Division omits an appraisal dated in March 2009 for the Rodney Kush loan, which reflected a value $1.5 million *higher* than the valuation TierOne had used at year-end 2008. Resp'ts Ex. 8M, KPMGTO 5490; Resp'ts Ex. 18J,KPMGTO 8157. When all seven loans are considered, the net increase in loan losses would be only $4.3 million. In the tens of millions of dollars in loan losses

TierOne reported in its year-end financial statements—this number simply did not trigger AU § 561. Johnigan Report at 81.[11]

VII.
THE DIVISION IGNORES MANAGEMENT'S FRAUD AGAINST THE PUBLIC AND THE AUDITORS

The Division, by narrowly focusing on a few appraisals from the beginning of 2009, misses the big picture yet again. The Division simply ignores the tremendously significant information that came to light just a few months later, information about TierOne's loan loss reserves that had been withheld from KPMG prior to the issuance of the 2008 audit report.

On October 6, 2009, shortly after commencing an on-site loan review, the OTS issued an exception report requiring TierOne to amend or restate its second-quarter 2009 financial statements. Resp'ts Ex. 38, TierOne Corp., Current Report (Form 8-K) (Oct. 13, 2009), at 2. Not long after that event, TierOne reported more than $120 million in additional provisions to its ALLL reserve for the third quarter 2009. Mr. Aesoph promptly took action upon learning of these two events, in initiating procedures intended to determine whether any part of the additional loan loss amount belonged in prior periods—including year-end 2008. It was Mr. Aesoph's probing inquiries that triggered a series of revelations, all culminating in KPMG's resignation as TierOne's auditor and the withdrawal of its 2008 audit opinion.

On October 13, only a week after the OTS's exception report, Mr. Aesoph spoke with Jerrod Witzel, the head of TierOne's Internal Audit Department, to find out if Internal Audit was aware of any possible instances of fraud at the Bank. Mr. Witzel provided Mr. Aesoph with a memorandum authored by David Frances, TierOne's Special Assets Executive. The

[11] A review at trial of each of the loans the Division invokes to support its AU § 561 allegations will further confirm this conclusion.

memorandum, not previously disclosed to the auditors, spelled out Mr. Frances's "concerns" about TierOne's financial health, including capital deficiencies and problems with the Bank's loan loss calculations. *See* Resp'ts Ex. 242.

Mr. Aesoph again took immediate action. He conferred with highly experienced and knowledgeable colleagues at KPMG, including the managing partner of KPMG's Omaha office, KPMG's Chicago-based Regional Professional Practice Partner, and members of KPMG's Department of Professional Practice located in New York City. Then he confronted the Chair of the TierOne Audit Committee and demanded a special investigation into the issues raised in the Frances memorandum.

The Committee retained an outside law firm, Foley & Lardner LLP, to carry out this special investigation. Instead of stopping there, however, Mr. Aesoph arranged for KPMG forensics personnel to shadow the law firm's investigation. His instincts proved correct; the forensics team discovered shortcomings in Foley & Lardner's document review. The law firm admitted its failure to identify various documents as relevant. When the firm re-tagged 4,000 documents, 18 turned out to be "key." Even after this respected law firm completed its work, Mr. Aesoph did not just accept the resulting report. His careful analysis of it found internal inconsistencies signaling to him that the report failed to resolve important questions he had raised when he instigated the investigation. Mr. Aesoph therefore directed the KPMG forensics team to keep digging.

Mr. Aesoph continued in pressing his investigation of the issues raised in the Frances memorandum until, in April 2010, he learned through a new OTS report that TierOne had developed a so-called "Reserve Analysis" early in 2009, before KPMG had issued its 2008 audit opinion. This Reserve Analysis detailed, on a loan-by-loan basis, a very different scope of loss

estimates than TierOne had previously disclosed to its auditors. It set forth "best case," "expected case," and "possible case" scenarios, with the "possible" case leading to over $100 million in additional loan losses. Resp'ts Ex. 236. Management had kept that document hidden for more than a year. The conspiracy of silence and deception was so pervasive that when TierOne's Board itself reviewed this important Reserve Analysis at least twice in mid-2009, all mention of it had been carefully omitted from the Board's minutes.

Mr. Aesoph immediately reviewed these findings with his KPMG colleagues as well as members of KPMG's Office of General Counsel. He and another KPMG partner then met with TierOne's OTS field representative in order to get to the bottom of this revelation. He wanted to understand how the new Reserve Analysis was developed, when it was developed, and how it affected TierOne's earlier financial statements.

On April 23, 2010, after concluding from his investigation that KPMG could no longer rely on Management's representations, Mr. Aesoph informed TierOne that KPMG was immediately resigning as independent auditor. On April 25, 2010, Mr. Aesoph formally advised the TierOne Audit Committee that KPMG was (1) withdrawing its audit opinion on TierOne's year-end 2008 financial statements; and (2) withdrawing its internal control assessment at year-end 2008. Resp'ts Ex. 40, TierOne Corp., Current Report (Form 8-K) (Apr. 29, 2010).

It is now clear that members of Management are indeed guilty of a collusive fraud that was designed to—and that did—mislead the public, federal regulators, and the KPMG audit team. Notably, there is no allegation here that Mr. Aesoph and his team could have discovered this fraud. Thus, no fair assessment of the professionalism that Mr. Aesoph exercised during the 2008 audit would be possible without considering the roadblocks that Management created through concerted illegal conduct. *See, e.g.*, AU § 316.12 ("[T]he characteristics of fraud

. . . may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud."); AU § 230.12 ("Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement.").

The Commission's civil complaints against key members of Management detail precisely how Management misled Mr. Aesoph and his audit team. For example, Don Langford, TierOne's Chief Credit Officer, outright concealed "available information that would require write-downs or additional reserves on TierOne's impaired loans." Langford Complaint ¶ 32. Mr. Langford helped prepare the damaging Reserve Analysis in early 2009 and then deliberately withheld it from KPMG. Indeed, the Division acknowledges in Mr. Langford's complaint (although not in Mr. Aesoph's) that "TierOne's outside auditor ultimately resigned from the TierOne engagement in April 2010 after it discovered the existence of the Best/Worst Case Scenario and that it had been withheld." *Id.* ¶ 82.

Mr. Langford was not alone. The fraud went all the way to the top of TierOne Management. The Commission has leveled similar allegations against Gilbert Lundstrom, TierOne's former Chairman and CEO, and James Laphen, TierOne's former President. Compl., *SEC v. Lundstrom*, No. 12-cv-343 (D. Neb. Sept. 25, 2012). In charging each of these former TierOne personnel with fraud, the Division specifically asserts that they intentionally deceived the KPMG audit team. *Id.* ¶¶ 73–75; Langford Complaint ¶¶ 97–98.

Mr. Aesoph's actions here illustrate the tenacity with which he practices his chosen profession. When it became clear to Mr. Aesoph that Management had deprived him of material information bearing on TierOne's financial statements, he relentlessly pursued the truth. These actions are also significant in showing how errors that existed in TierOne's financial statements as of year-end 2008 were the product of Management's law-breaking and deception, not professional misconduct by the auditors.

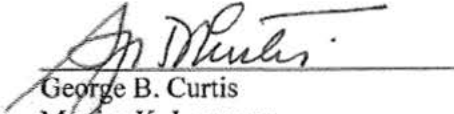
VIII.
CONCLUSION

This case illustrates the wisdom in Rule 102(e)'s bar on discipline-through-hindsight. At year-end 2008, the real estate market and the economy in general were in the throes of rapid transition. As trillions of dollars in stock market values were being lost, professionals faced unprecedented challenges in estimating the fair value of any asset tied to real estate.

Mr. Aesoph's work on the 2008 audit and its aftermath demonstrate professionalism, due care, and a devotion to the pursuit of competent evidential matter. He allocated proper resources to the audit, planned the audit to address all major areas of risk, and devoted sufficient attention to the work papers to understand the evidence and form his conclusions. In doing so under these challenging conditions, he met all professional standards. He is not a threat to the Commission's processes and should not be sanctioned under Rule 102(e).

Dated: August 29, 2013

Respectfully submitted,



George B. Curtis
Monica K. Loseman
Counsel for John J. Aesoph
(303) 298-5743 (Curtis)
(303) 298-5784 (Loseman)
gcurtis@gibsondunn.com
mloseman@gibsondunn.com