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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15168

Carol Fox Foelak
Administrative Law Judge

In the Matter of

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

Respondents.

RESPONDENT DARREN M. BENNETT'S PRE-HEARING BRIEF

August 29, 2013

Gary F. Bendinger
Kevin A. Burke
SIDLEY AUSTIN LLP
787 Seventh Avenue
New York, NY 10019
Telephone: (212) 839-5300
Facsimile: (212) 839-5599

Attorneys for Respondent Darren M. Bennett

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I. INTRODUCTION

Respondent Darren Bennett, a senior manager within KPMG's audit practice, is an earnest, competent professional who worked tirelessly during a volatile economic time to assist in planning and executing the 2008 integrated audit of TierOne's internal controls over financial reporting and financial statements. He should not be sanctioned under Rule 102(e) because, as the evidence will show, he complied with professional standards and poses no threat to the Commission's processes.

The Division of Enforcement ("Division") charges Mr. Bennett based on purported deficiencies in KPMG's audit work regarding a *component* of one assertion in TierOne's financial statements—the estimated reserves for non-homogenous impaired loans within the allowance for lease and loan losses ("ALLL"). Statement of Financial Accounting Standards No. 114 ("FAS 114") required TierOne to evaluate impairment on a loan-by-loan basis, and TierOne recorded reserves based on the estimated fair value of collateral. Management's ALLL estimate, including its component FAS 114 reserves, is highly subjective. And an auditor's assessment of that estimate is a matter of professional judgment. *See* Respondents' Exhibits ("Resp. Exs.") 57, 61, AU §§ 312.36, 342.14.

Ignoring evidence and misconstruing applicable guidance, the Division contends that KPMG should not have issued an unqualified audit report because it failed to identify and test adequate controls relating to the valuation of collateral for impaired loans and failed to conduct sufficient substantive procedures relating to management's estimates. In effect, however, its contention is that the accounting literature requires banks to obtain for all impaired loans "current" appraisals and that the audit literature somehow requires auditors to enforce this supposed requirement. And that KPMG should have audited individual appraisals, rather than TierOne's financial statements as a whole, and otherwise applied market data as the sole

determinant of fair value. That is neither consistent with professional standards nor what reasonable auditors do. The Division cannot meet its standard of proof against Mr. Bennett.

The KPMG engagement team complied with professional standards in performing the 2008 integrated audit of TierOne's internal controls and financial statements. As acknowledged by the Order Instituting Public Administrative Proceedings ("Order"), the team properly identified the ALLL as a significant account subject to a high inherent risk of material misstatement. The team further gained an understanding of TierOne's methodology for estimating its ALLL, identified and tested key internal controls, performed substantive audit procedures, and appropriately concluded that TierOne's ALLL was reasonable in the context of the 2008 financial statements taken as a whole. Aware of the volatile market conditions that prevailed during 2008—along with increased capital ratios and the examination findings issued in October 2008 by TierOne's regulators at the Office of Thrift Supervision ("OTS")—the engagement team enhanced their audit procedures accordingly. They performed more testing on more impaired loans, they engaged regulatory and credit risk specialists from within the firm to assist with their audit procedures, they reached out to the OTS directly to discuss management's response to regulatory findings, and they diligently pursued management to understand its rationale for the ALLL estimate.

The engagement team spent 50% more hours (2,600 versus 1,700) on the interim review and year-end audit procedures in 2008 than in 2007, and Mr. Bennett personally spent almost 90% more hours (400 versus 215). These increased efforts were devoted substantially to evaluating the ALLL, including the FAS 114 reserve estimates, *i.e.*, the aspect of the audit the Division now challenges. This is not the picture of an auditor who poses a threat to the Commission's processes.

In the stark light of 20/20 hindsight, including full knowledge of the ultimate severity and duration of the economic crisis—and of a collusive fraud perpetrated by management against KPMG—the Division second-guesses the professional judgments made in good faith during a challenging time. This is not what Rule 102(e) is designed to address. Regardless of any purported shortcomings in the team's work, Mr. Bennett should not be sanctioned.

II. LEGAL STANDARD

The Order does not contain any allegation of intentional misconduct. To prevail, the Division must prove that Mr. Bennett committed a single instance of highly unreasonable conduct or repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards. 17 C.F.R. § 201.102(e)(1)(iv)(B)(1)-(2); *see also Marrie v. SEC*, 374 F.3d 1196, 1206-08 (D.C. Cir. 2004). Rule 102(e) reaches only grave misconduct that establishes unequivocally that the accountant lacks "competence." Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164, 57,166 (Oct. 26, 1998) ("Rule 102(e) Release"). With respect to either prong of Rule 102(e), the Division must demonstrate that the conduct reflects a lack of competence. Sanctions are reserved for such cases because they can "deprive a person of a way of life ... on which he and his family have come to rely." Rule 102(e) Release, 63 Fed. Reg. at 57,169, 57,173.

As to the repeated instances prong, the Division must establish at least "two *separate* instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits." *See* Rule 102(e) Release, 63 Fed. Reg. at 57,169 ("For example, if an auditor fails to gather evidential matter for more than two accounts, or certifies accounting inconsistent with GAAP in more than two accounts, that conduct constitutes 'repeated instances.'"). There are times when "'repeated instances' may not ... demonstrate a

lack of competence to practice before the Commission." Rule 102(e) Release, 63 Fed. Reg. at 57,169. Even "two isolated violations of applicable professional standards, for example GAAS, may not pose a threat to the Commission's processes." *See* Rule 102(e) Release, 63 Fed. Reg. at 57,169.

Rule 102(e)(1)(ii) is not meant to encompass every professional misstep or error in judgment, even if unreasonable when made. *See* Rule 102(e) Release, 63 Fed. Reg. at 57,166. Rather, the Rule is designed for conduct evidencing "an unfitness to practice before the Commission" and to allow it to protect itself from "the clear incompetence of incorrigibly inept professionals" and "miscreants." *In re Potts*, Release No. 39126, 53 SEC Docket 187, 1997 SEC LEXIS 2005, at *57 (Sept. 24, 1997) (Comm'r Wallman, dissenting). The Commission must avoid characterizing as negligent "difficult judgment calls made by a professional – which subsequently prove to be incorrect." *In re Potts,* 1997 SEC LEXIS, at *57. It is not appropriate to "evaluate [an accountant's] actions or judgments in the stark light of hindsight" rather than by assessing how a "reasonable accountant" would act "faced with the same situation" and "at the time of the [alleged] violation." Rule 102(e) Release, 63 Fed. Reg. at 57,168. While the Division may disagree with certain judgments, any determination regarding the unreasonableness of conduct may not be based on "subjective second-guessing of auditing judgment calls." *Marrie*, 374 F.3d at 1206.

Thus, only in extreme cases has the Division obtained Rule 102(e) sanctions against a non-partner auditor who did not have ultimate responsibility for the audit. Those rare cases involve egregious conduct, such as ignoring a significant issue, creating workpapers after-the-fact, or withholding significant information from the engagement partner. *See, e.g.*, *In re Oprins & McNeeley*, Release No. ID-411, 2010 SEC LEXIS 4450 (Dec. 28, 2010) (failure to review key

audit areas and to inform partner of relevant information); *In re Dohan & Co.*, Release No. ID-420, 2011 SEC LEXIS 2205 (June 27, 2011) (failure, despite skyrocketing revenues, to conduct walk-throughs of revenue system or sales cycle).

Because its allegations relate to a single account (the ALLL), the Division must prove that Mr. Bennett engaged in "highly unreasonable" conduct that violated professional standards, and that he is incompetent and a continuing threat. The Division can prove none of this.

III. APPLICABLE PROFESSIONAL STANDARDS

A. Accounting Principles

TierOne management was responsible for reporting its financial results, including its ALLL, in accordance with generally accepted accounting principles ("GAAP"). An ALLL is "an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date." Resp. Ex. 64, AICPA Audit and Accounting Guide: Depository and Lending Institutions § 9.01 ("AAG-DEP"); Resp. Ex. 47, SAB 102. It is not a prediction of future losses. *See* Resp. Ex. 67 at Interagency Policy Statement on the Allowance for Loan and Lease Losses, KPMGTO00054156-177, at 54158 n.7 (Dec. 13, 2006). Rather, losses must be recognized only when they are probable and estimable as of the date of the financial statements. Resp. Ex. 46, FAS 5 ¶ 8. The ALLL has two components, an estimate under FAS 5 for homogenous loans and an estimate under FAS 114 for individual impaired loans. Resp. Ex. 46, FAS 5; Resp. Ex. 44, FAS 114. Here, TierOne's impaired loans constituted less than 7% of its total loan portfolio.

A loan is impaired "when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." Resp. Ex. 44, FAS 114 ¶ 8. Measuring impairment "requires judgment and

estimates, and the eventual outcomes may differ from those estimates. Creditors should have latitude to develop measurement methods that are practical in their circumstances." Resp. Ex. 44, FAS 114 ¶ 11. "It is usually difficult, even with hindsight, to identify any single event that made a particular loan uncollectible." Resp. Ex. 48, Emerging Issues Task Force ("EITF") Topic No. D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio, Ex. D-80A, Overview. Compounding the difficulty, the Financial Accounting Standards Board ("FASB") has not provided creditors with guidance in determining when "it will be unable to collect all amounts due according to a loan's contractual terms." Resp. Ex. 48, EITF D-80, Ex. D-80A, Q.9.

If a loan is deemed impaired, management must determine whether an allowance is appropriate pursuant to FAS 114. Estimating the fair value of the collateral securing the loan typically is required. According to FAS 157, first effective for TierOne's 2008 fiscal year:

> A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities … .

Resp. Ex. 45, FAS 157 ¶ 7. In September 2008, following an initial period during which practitioners attempted to adjust to the new guidance, the SEC Office of the Chief Accountant and the FASB Staff issued *Clarifications on Fair Value Accounting*, which explains that "[d]istressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence." Resp. Ex. 66, SEC Release No. 2008-234, Clarifications on Fair Value Accounting. Also, "[t]he

results of disorderly transactions are not determinative when measuring fair value."[1] Resp. Ex. 66, SEC Release No. 2008-234, Clarifications on Fair Value Accounting.

As explained in the expert report of Sandra Johnigan, C.P.A, on behalf of Respondents, there are at least two significant aspects of FAS 157 ignored by the Division that are important in evaluating the auditing of TierOne's FAS 114 loans.[2] *First,* as documented in KPMG's workpapers, TierOne management concluded that "'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."[3] Management's view of the markets is consistent with the expert opinion of Professor Chris James on behalf of Respondents. That is, 2008 through early 2009 in particular was a time of great volatility and uncertainty in the U.S. economy and real estate markets. Industry participants and academics recognized that there had been an increase in forced sales creating disorderly markets and a perception that real estate appraisals were less reliable given that they often did not represent "orderly transactions."[4] All this made it increasingly difficult to estimate fair value based on comparable sales information, particularly in TierOne's riskier markets.[5] Thus, while TierOne did not ignore market data in areas such as Nevada, neither did it view such data as determinative of fair value (and, as discussed *infra* in Section V.F, this was not evidence of management bias).

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[1] As explained in the expert report of Professor Chris James on behalf of Respondents, the Division's economist focuses on market data as opposed to fair value. Moreover, his market data improperly includes distressed sales. Both factors render the Division's economic analysis inapplicable. *See* Resp. Ex. 43, James Report at 3-4; *see also* Respondents' *First* Joint Motion in Limine – To Exclude the Report and Testimony of Anjan V. Thakor.

[2] Ignoring key concepts in the accounting, and auditing, literature, the Division seems intent on imposing its own interpretations not in effect at the time, if ever. *See* Mr. Bennett's Second (Failure to Provide Fair Notice), Third (Due Process/Retroactivity), Fourth (Due Process/Vagueness) and Fifth (Due Process/Procedure) Affirmative Defenses.

[3] Resp. Ex. 8K, L-30A, Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5450, 5458.

[4] Resp. Ex. 43, James Report at 10-14.

[5] Resp. Ex. 43, James Report at 11-13.

Second, TierOne disclosed in its financial statements that "[o]n January 1, 2008 we adopted SFAS No. 157," and for FAS 114 loans it relies "on external appraisals and assessment of property values by our internal staff. . . . Because many of these inputs are not observable, the measurements are classified as Level 3."[6] "Unobservable inputs" and "Level 3" are terms from FAS 157 that describe the lowest tier of input used in fair value measurements. Such inputs are used for assets such as "large, unique" real estate projects that are unlikely to have quoted market prices. FAS 157 states:

> [U]nobservable inputs *shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset* or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort.

Resp. Ex. 45, FAS 157 ¶ 30 (emphasis added). Thus, estimating fair value is complex and nuanced. It is not conducive to applying uniform discounts to older appraisals, simply ordering new appraisals in a disorderly market, or relying solely on macro-economic data as suggested by the Division's experts.[7]

B. Auditing Standards

While internal controls over financial reporting ("ICOFR") and the financial statements are management's responsibility, the auditor's responsibility is to express an opinion on ICOFR and the financial statements. *See* Resp. Ex. 52, AU § 110.03. The auditor's objective is to

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[6] Resp. Exs. 1E and 36, TierOne 2008 10-K, Note 22, at 117, 120.

[7] Notwithstanding its allegations in this proceeding, the Division admitted in separate proceedings against TierOne's principals that a "recent appraisal" is *not* necessary to the appropriate determination of fair value. *See* Resp. Ex. 234, Complaint ¶ 28, *SEC v. Lundstrom et al.*, No. 12-cv-00343 (D. Neb. Sept. 25, 2012); Resp. Ex. 235, Complaint ¶ 22, *SEC v. Langford*, No. 12-cv-00344 (D. Neb. Sept. 25, 2012); *see also* Mr. Bennett's Sixth (Arbitrary and Capricious) and Ninth (Estoppel/Fraud Allegations) Affirmative Defenses; Respondents' *Third* Joint Motion In Limine – To Consider and Rely on Judicial Admissions Set Forth In The Commission's Related Complaints.

"obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment." Resp. Ex. 55, AU § 230.10. In order to arrive at an opinion, the auditor seeks "to obtain sufficient appropriate evidential matter to provide him or her with a reasonable basis for forming an opinion." Resp. Ex. 55, AU § 230.11.[8]

Expressing an audit opinion requires the exercise of professional judgment and, "[e]ven with good faith and integrity, mistakes and errors in judgment can be made." Resp. Ex. 55, AU § 230.11. Judgment is involved in selecting "areas to be tested and the nature, timing, and extent of the tests to be performed," "interpreting the results of audit testing and evaluating audit evidence," and "evaluating the reasonableness of accounting estimates." Resp. Ex. 55, AU § 230.11. The auditor also must exercise judgment in determining the quality of audit evidence. Resp. Ex. 59, AU § 326.02. This involves evaluating the amount and kind of evidence obtained, relying "in the great majority of cases ... on evidence that is persuasive rather than convincing." Resp. Ex. 59, AU § 326.22; *see also* Resp. Ex. 55, AU § 230.11. Notably, fraud may be concealed through collusion among management, and "[c]ollusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false."[9]

The auditor is responsible for evaluating the reasonableness of management estimates "in the context of the financial statements taken as a whole." Resp. Ex. 61, AU § 342.04. "[T]he auditor should obtain an understanding of how management developed the estimate" and then

[8] The professional standards explain that "the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in [ICOFR] exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States)." Resp. Ex. 55, AU § 230.13. Indeed, "[b]ecause of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement." Resp. Ex. 55, AU § 230.12.

[9] Resp. Ex. 42, Johnigan Report at 19 & n.61 (citing AU § 316.10).

either (i) "[r]eview and test the process used by management"; (ii) "[d]evelop an independent expectation of the estimate"; or (iii) "[r]eview subsequent events or transactions occurring prior to the date of the auditor's report." Resp. Ex. 61, AU § 342.10. Here, KPMG complied with the standard by reviewing and testing management's process, as documented in the workpapers. Because of the subjectivity inherent in estimates, "no one accounting estimate can be considered accurate with certainty." Resp. Ex. 57, AU § 312.36; *see also* Resp. Ex. 61, AU § 342.14. "A difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." Resp. Ex. 57, AU § 312.36. Moreover, "the 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* Resp. Ex. 60, AU § 328.38; *see also* Resp. Ex. 64, AAG-DEP § 9.45 (auditor is "not responsible for estimating the amount of the allowance or ascertaining the collectability of each, or any, specific loan").

As Ms. Johnigan explains in her expert report, the Division and its experts distort the key concepts in these standards. They ignore the inherent limitations on what an auditor can do. An auditor's responsibility is not to determine if the financial statements contain the "right amount" for loan losses, or even to determine if the financial statements contain the amount "best supported by the audit evidence."[10] Instead, the auditor's responsibility is to assess whether management's estimate is within a *reasonable* range. It is an important responsibility, not to be taken lightly, but very different from the responsibility the Division seeks to ascribe to Mr. Bennett.

[10] Resp. Ex. 42, Johnigan Report at 14.

IV. BACKGROUND OF 2008 AUDIT ENGAGEMENT

TierOne was a regional community bank that originated loans to customers in Nebraska, Iowa, and Kansas, its primary market area, after having closed in the third quarter 2008 loan production offices ("LPOs") in other states, including Nevada, Arizona and Florida. The OTS regulated TierOne and conducted annual inspections, including a 2008 examination documented in a Report of Examination ("ROE") issued in October 2008.

At year-end 2008, TierOne had a loan portfolio of $2.8 billion, and its ALLL was $63.2 million, or 2.27% of net loans.[11] The substantial majority of this loan portfolio—$2.6 billion of the total $2.8 billion—consisted of loans not deemed impaired and accounted for under FAS 5.[12] Estimated reserves for these non-impaired loans was $46.8 million, or 74% of the total ALLL. TierOne's impaired loan balance was $185.9 million.[13] The reserves on impaired loans totaled $16.4 million after 2008 charge-offs totaling $90.4 million, a substantial portion of which pertained to impaired loans.[14]

KPMG had served as TierOne's independent auditor since before the bank went public in 2002. In 2008, the engagement team included an engagement partner (Respondent John Aesoph), an SEC concurring review partner (Terry Kenney), a senior manager (Mr. Bennett), a senior, an associate, and a variety of specialists from different practices within KPMG.

Mr. Aesoph, as the engagement partner, had overall responsibility for the audit and for approving and signing KPMG's audit reports.[15] He is an experienced partner who had focused

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[11] Resp. Exs. 1E & 36, TierOne 2008 10-K Note 5, at 95-96.

[12] *See* Resp. Ex. 8U, L-37A Loan Delinquencies by State, KPMGTO0005577-78, at 5578; Resp. Ex. 8Q, L-35A Impaired Loans, KPMGTO0005556-63, at 5563.

[13] Resp. Exs. 1E & 36, TierOne 2008 10-K at 55; Resp. Ex. 8L, L-31 Series, at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75, at 5475; Resp. Ex. 8Q, L-35A Impaired Loans, KPMGTO0005556-63, at 5563.

[14] Resp. Ex. 8L, L-31 Series, at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75, at 5475; Resp. Ex. 1E & 36, TierOne 2008 10-K, Note 7 at 55.

[15] *See* Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3655-56.

his career on auditing financial institutions, including banks.[16] He had worked on the TierOne audits, initially as a manager and then a partner, since 2002.[17] He was involved in developing and ultimately approved the audit plan. He consulted with the SEC concurring review partner throughout the audit and supervised Mr. Bennett. Devoting particular attention to the ALLL, he reviewed all significant workpapers, including those regarding management review of impaired and non-performing loans, loan reviews conducted by KPMG's credit risk specialist, and management's FAS 114 reserve templates.[18]

Mr. Kenney, the SEC review partner, was responsible for providing a second partner-level review of the significant decisions and judgments made by the engagement team and, ultimately, KPMG's audit report.[19] He was a senior partner and a financial services practice leader with twenty years of financial industry experience.[20] He reviewed and approved the 2008 audit plan,[21] consulted regularly with Messrs. Aesoph and Bennett during the audit, including

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[16] Aesoph Tr. at 16-17, 21.
[17] Aesoph Tr. at 22-23.
[18] *See, e.g.*, Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3648, 3666; Resp. Ex. 3A, B-1 Audit Checklist - Integrated, KPMGTO0003425-53, at 3426-31, 3449; Resp. Ex. 1, Year-End 2008 Workpaper Binder (1/12) at Report Docket Forms, KPMGTO0002046-55; Resp. Ex. 7E, L-6 Test of Design and Operating Effectiveness Template – Integrated – Management Review of Impaired Loans, TDR's and Non-Performing Loans, KPMGTO0005074-77; Resp. Ex. 8, Year-End 2008 Workpaper Binder (8/12) at L-21.6 GAAP Loans, KPMGTO0005275; Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77; Resp. Ex. 8C, L-22.1 Loan Reviews Summary, KPMGTO0005280; Resp. Ex. 8D, L-22.1A KPMG Financial Risk Management External Audit Assist Credit Risk Review Report – Interim Review June 23, 2008 as of March 31, 2008, KPMGTO0005281-91; Resp. Ex. 8E, L-22.1B KPMG Financial Risk Management External Audit Assist Credit Risk Review Report Interim Review 9/30/08, KPMGTO0005292-98; Resp. Ex. 8H, L-22.2 IA Loan Reviews, KPMGTO0005344-412; Resp. Ex. 8H, at L-22.2A Lunar Vail, LLC, KPMGTO0005345-49; Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31; Resp. Ex. 8L, L-31 Series at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75; Resp. Ex. 8L, L-31 Series at L-31.1 SAB 102 and Loss Factor Analysis, KPMGTO0005476-81; Resp. Ex. 8M, L-32 Series at L-32 FAS 114 Procedures, KPMGTO0005482-83; Resp. Ex. 8M, L-32 Series at L-32A FAS 114 Summary, KPMGTO0005484; Resp. Ex. 8M, L-32 Series at L-32.1 FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-5548.
[19] *See* Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3656.
[20] Kenney Tr. at 21-25, 33.
[21] *See* Resp. Ex. 3A, B-1 Audit Checklist – Integrated, KPMGTO0003425-53, at 3450-53; Kenney Tr. at 62-63, 161.

with respect to the OTS ROE issued in October 2008, and reviewed and approved all significant conclusions, including with respect to the reasonableness of TierOne's ALLL estimate.[22]

Mr. Bennett had been a member of the TierOne engagement team since 2003, with the exception of the 2006 fiscal year, resulting in cumulative knowledge of the audit client based on years of experience.[23] During the 2008 audit, he had been with KPMG for eight years, had been a senior manager for one year, and was 31 years old.[24] He had taken training courses particularly relevant to the engagement, including audit issues specific to the banking industry and the economic environment, and had far exceeded his overall continuing education requirements.[25] Supervised by Messrs Aesoph and Kenney, he helped oversee the team's day-to-day work.[26] He regularly worked onsite at TierOne, interacted extensively with and directly supervised the audit staff, and regularly reported to and communicated with Mr. Aesoph.[27] KPMG continues to support the judgments reached by Mr. Bennett, and, apart from this matter, Mr. Bennett has never been the subject of any disciplinary proceeding.

Beth Burke (née Houlihan), the senior, and Jackie Abel (née Dvoracek), the staff accountant, performed day-to-day audit work, including, for example, control walkthroughs and substantive testwork.[28] Mr. Bennett interacted extensively with each one, reviewing their work and, often involving them in firm activities to broaden their understanding of issues relevant to auditing financial industry clients.

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[22] Kenney Tr. at 60-61, 88-89, 215-19.
[23] Bennett Tr. at 15, 17.
[24] Mr. Bennett earned a Bachelor's degree in Business Administration in 1999 and a Masters of Professional Accountancy in 2000 from the University of Nebraska at Lincoln. He received his CPA license in 2006. *See* Division Ex. 232 at 9-10, Background Questionnaire – Darren Bennett (Inv. Ex. 133).
[25] Resp. Ex. 208, 2006-2008 KPMG CPE Summary for D. Bennett, KPMGTO00059535-40.
[26] *See* Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3656; Bennett Tr. at 23.
[27] *See, e.g.*, Bennett Tr. at 24-26, 42-43, 54-56.
[28] *See* Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3656.

A credit risk specialist (Sandra Washek) from the Financial Risk Management practice reviewed loan files on several occasions throughout 2008.[29] Two specialists from the Financial Services Regulatory Practice reviewed the OTS's findings and supervisory conduct relating to TierOne. And forensic specialists assisted in the consideration of the risk of fraud.[30]

V. MR. BENNETT MET PROFESSIONAL STANDARDS

It is not enough for the Division to criticize KPMG's issuance of an unqualified audit opinion or to point to purported deficiencies in the audit or the engagement team's work. The Division must prove that *Mr. Bennett* engaged in misconduct in violation of Rule 102(e).

A fair evaluation of Mr. Bennett's conduct cannot take place in a vacuum. Rather, his conduct must be assessed for what it was—the contribution of one member of an engagement team, and not the one ultimately responsible for the audit. To be sure, Mr. Bennett's role as senior manager was important, and he understood that he was bound to comply with professional standards, which he did. But it is significant, and this Court should not disregard, that his work was closely supervised and that he regularly consulted with his superiors, who ultimately concurred with the reasonableness of his professional judgments.

During the 2008 integrated audit, Mr. Bennett and the engagement team were well aware of the troubling market conditions, the aggressive OTS findings, and the increased capital ratios. They appropriately assessed the financial statement risks and enhanced their procedures accordingly, at interim as well as at year-end. This manifested itself in an overall increase in hours by more than 50%—and by Mr. Bennett personally, 90%. And, throughout the year, he observed management continuing to charge off significant amounts and recording increased loan

[29] *See* Resp. Exs. 8B – 8H L-22 Series, KPMGTO0005276-5412.
[30] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3656-57, 3666-67.

loss reserves. Nothing about this picture suggests auditor incompetence or a threat to the Commission's processes.

As the evidence will show, and as described more fully below, Mr. Bennett appropriately assisted in planning the 2008 audit (Section V.A) and considering the findings of the OTS (Section V.B). He appropriately assisted with internal controls testing (Section V.C) and substantive procedures relating to TierOne's ALLL, including its FAS 114 reserves (Section V.D). He appropriately considered the potential for management bias. (Section V.F) And, in all respects, the team sufficiently documented its work, which itself requires professional judgment. *See* Resp. Ex. 49, AS No. 3.

A. Appropriately Assisted with Planning

Audit planning involves a variety of work that takes place throughout the fiscal year. The work conducted here in planning the audit of TierOne's 2008 financial statements is essential to understanding the audit in its entirety.

As an initial matter, Mr. Bennett and the engagement team established and documented their understanding of TierOne's business and industry. They noted that TierOne operated through a network of sixty-nine banking offices in Nebraska, Iowa and Kansas, and previously nine LPOs in Arizona, Colorado, Florida, Minnesota, Nevada and North Carolina, which TierOne had closed earlier in 2008 in light of adverse market conditions.[31] They were well aware of and documented the downturn in the banking sector due to "delinquencies in the housing and real estate markets"[32] and specifically noted the "bank is susceptible to financial loss

[31] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3663.
[32] Resp. Ex. 3F, C-2 Client Risk Assessment Summary, KPMGTO0003697-99, at 3699.

in the event of credit default by its customers."[33] Likewise, they documented the trend since 2007 in non-performing loans, charge-offs, and provisions.[34]

Mr. Bennett and the engagement team developed and documented their understanding of TierOne's internal controls. They considered TierOne's accounting policies and procedures and noted changes, including increased oversight with respect to the ALLL, non-performing loans, and impaired loans.[35] They documented the lack of significant deficiencies and material weaknesses in 2007 and the fact that TierOne's direct controls tested in prior years were found to be effective, with no deficiencies in indirect entity level controls.[36] At the same time, they noted that TierOne's Internal Audit had identified a significant deficiency in the third quarter 2008—deemed to be remediated at year-end—relating to internal asset review ("IAR") and documentation of loss factors relating to FAS 5 reserves regarding homogenous loans.[37] They noted that Internal Audit generally oversaw the assessment of ICOFR, updated prior year control documentation, and periodically communicated with management regarding testing results.[38] They assessed the Internal Audit group itself, including with respect to independence, and concluded that it "possessed a high degree of competence and objectivity."[39] And they identified areas as to which they planned to rely on Internal Audit, which appropriately excluded "areas of

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[33] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3663.
[34] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3651-52.
[35] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3660, 3663-64.
[36] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3660, 3665, 3668-69.
[37] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3665; Resp. Ex 3, Year-End 2008 Workpaper Binder (3/12) at B-8.1 Deficiencies in ICOFR, KPMGTO0003627-28, at 3628.
[38] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3664, 3669-70.
[39] Resp. Ex. 3H, C-5.1 IA Reliance Approach Memo, KPMGTO0003726-28, at 3727; *see also* Resp. Ex. 4, Year-End 2008 Workpaper Binder (4/12) at D-5 Entity Level Control – Control Environment, KPMGTO0003852-54, at 3853-54 (testing the design and operating effectiveness of controls relating to the Audit Committee, including its oversight of Internal Audit and review of internal audit reports, as well as the independence of Internal Audit through its reporting to the Audit Committee, and concluding such controls were designed appropriately and operating effectively).

high risk of failure and fraud risks." *See* Resp. Ex. 50, AS No. 5, ¶¶ 17-18; Resp. Ex. 58, AU § 322.09, .11.[40]

Especially pertinent here, Mr. Bennett and the engagement team noted that, following issuance of the OTS ROE in October 2008 (discussed further below), management was "implementing new controls and modifying existing controls." These initiatives included: (1) forming an additional committee to monitor the loan portfolio and review past due loans; (2) developing a migration analysis to assist in estimating the ALLL, (3) reviewing the status of construction loan projects; and (4) reviewing and approving disbursed funds.[41]

With this understanding of internal controls, Mr. Bennett and the engagement team considered risks of potential material misstatement. They prepared a planning matrix that documented risk assessments by financial statement line item, including with respect to the risk of fraud. They considered prior year-end balances and current interim balances and addressed relevant assertions, a description of each risk, and the planned audit approach and procedures.[42] Forensic specialists from within the firm assisted the engagement team in these assessments.[43] Specifically, in a December 2, 2008 conference call, which Mr. Bennett was responsible for scheduling and leading in part, the engagement team discussed audit planning and fraud risk and prepared a summary of identified risks, including the risk that the ALLL could be "improperly calculated or monitored" or "inadequate."[44] They discussed "current market conditions and impact on the audit" and the importance of professional skepticism throughout, and they

[40] Resp. Ex. 7C, LC Using the Work of Internal Audit – Loans, KPMGTO0005029-33, at 5029-31; Resp. Ex. 3H, C-5.1 IA Reliance Approach Memo, KPMGTO0003726-28, at 3727.
[41] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3663-65.
[42] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3678-87; 3690-91, 3697-99.
[43] Resp. Ex. 227, 11/25/08 Email from D. Bennett to engagement team and M. Manning (Manager, KPMG Forensic), copying M. Humphrey (Manager, KPMG Forensic) Re TierOne Planning Discussion Update, KPMGTO-E-00017559-62 (attaching Planning Meeting Agenda including fraud discussion); Resp. Ex. 184, 12/2/08 Email from M. Manning to engagement team, copying M. Humphrey Re TierOne Planning Discussion Update, KPMGTO-E-00093070-81 (attaching Forensic In The Audit PowerPoint Presentation).
[44] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3656, 3666-67, 3675-76.

considered fraudulent transactions perpetrated by certain borrowers (Transland), noting that while the fraud did not appear to involve TierOne employees, the team "will continue to have a heightened sense of awareness as it relates to the credit issues experienced at TierOne and the general trends in the banking industry when completing our test work over loan valuation."[45]

In assessing risks, Mr. Bennett and the engagement team appropriately identified TierOne's ALLL as a significant account. They concluded that the inherent risk associated with the ALLL was "High", noting that the account "is subject to judgment and requires specific knowledge and competencies" of the Bank's Risk Management Department. In this context, they again acknowledged "the increase in non-performing loans, charge-offs and provisions due to the current economic environment..."[46]

Mr. Bennett and the engagement team obtained a thorough understanding of TierOne's methodology for estimating ALLL, including both the FAS 5 and the FAS 114 components. Pursuant to FAS 5, TierOne estimated reserves for groups of non-impaired loans by applying loss factors based on historical experience.[47] Management applied larger loss factors to portfolios of higher risk rated loans.[48] Essential to this process, management periodically evaluated and assigned loans a risk rating from 1 to 9—1 through 4 indicated varying degrees of "Pass", 5 indicated "Special Mention", 6 indicated "Substandard", and 7 through 9 indicated varying degrees of "Loss."[49] Management then evaluated individual loans, typically risk rated Substandard or worse, for impairment.[50] Key members of management were involved in these

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[45] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3667-68, 3689.
[46] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3663, 3679, 3684-85.
[47] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5435.
[48] Resp. Ex. 8L, L-31 Series, at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75.
[49] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5436.
[50] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5434.

evaluations, including Gale Furnas, the Chief Lending Officer, Don Langford, the Chief Credit Officer, David Kellogg, the Controller, and David Frances, the Special Assets Executive brought on board to improve certain processes in August 2008.[51] If a loan was deemed impaired, these same key members of management evaluated the facts and circumstances applicable to each one in determining whether a reserve was appropriate pursuant to FAS 114. Specifically, management had "developed a discounted cash flow model and a collateral-dependent fair value model"—invoking in most instances the latter methodology, pursuant to which loan balance amounts in excess of the collateral's fair value were regarded as uncollectible and charged off—to estimate individual reserves on impaired loans with funded balances that exceeded $1 million.[52] Management documented these reserve estimates quarterly in a "FAS 114 template" for each impaired loan, charging off the difference between the impaired loan's book value and estimated fair value and recording a reserve in the amount of the estimated selling costs and present value of the collateral.[53]

Given the heightened risks, Mr. Bennett and the engagement team planned to increase—and ultimately did increase—their interim and year-end audit procedures with respect to the ALLL.[54] As discussed further below, one manner in which they did so was to engage Ms. Washek, a KPMG credit risk specialist, on *three* separate occasions during interim and at year-end to test, among other aspects of the process, management's risk rating to determine if there was a systemic problem. Ms. Washek was well qualified to perform this assessment given

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[51] Messrs. Kellogg, Furnas and Langford also were members of the Asset Classification Committee, which, as discussed *infra* Section V.C.2.c, was responsible for reviewing the output of processes in place to identify and classify potential problem assets and for ensuring adequate ALLL reserves.
[52] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5434-35, at 5434.
[53] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5434-35; Resp. Ex. 8L, L-31 Series at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75.
[54] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3651-52.

her education, prior engagements for similar financial institutions, and prior employment as a bank Commercial Credit Officer.[55] Notably, it was not a requirement that the engagement team involve a credit risk specialist *at all*.[56]

In addition to recording a FAS 5 reserve and FAS 114 reserves, TierOne maintained an unallocated reserve as permitted by interagency guidance.[57] Management documented its rationale for the unallocated reserve, noting it was appropriate in light of inherent uncertainty and difficulty in estimating losses in volatile markets.[58] At December 31, 2008, TierOne recorded an unallocated reserve of $3.9 million, reflecting a significant increase from $204,000 at December 31, 2007.[59]

Finally, Mr. Bennett and the team considered SEC Staff Accounting Bulletin: No. 102—Selected Loan Loss Allowance Methodology and Documentation Issues ("SAB 102"). They documented that TierOne (1) included "a detailed analysis of the loan portfolio, performed on a regular basis"; (2) considered "all loans (whether on an individual or group basis)"; (3) identified "loans to be evaluated separately for impairment on an individual basis under FAS 114 and segment[ed] the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation under FAS 5"; (4) considered "all known relevant internal and external factors that

[55] Division Ex. 234, Background Questionnaire – Sandra Washek (Inv. Ex. 156), SEC-WASH000003-14, at 11, 13 (Ms. Washek holds a B.A. in Accounting from the University of Notre Dame, and a M.M.A. in Finance from Northwestern University's Kellogg School of Management, and previously worked at Centier Bank in Merrillville, Indiana).

[56] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3654, 3656-57; Resp. Ex. 3, Year-end 2008 Workpaper Binder (3/12), at C-13 Involvement of Credit Risk Specialist in an Audit, KPMGTO0003781-83.

[57] *See* Resp. Ex. 67 at Q&A on Accounting for Loan and Lease Losses, KPMGTO0054178-91, at 54188-89 Question #13 (Dec. 13, 2006); Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5426.

[58] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5467.

[59] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5432; Resp. Ex. 8L, L-31 Series at L-31 ALLL Detail (FAS 5 Calculation), KPMGTO0005470-75, at 5475.

may affect loan collectability"; and (5) had a policy that was "well documented, in writing, with clear explanations of the supporting analyses and rationale."[60]

B. Appropriately Considered OTS Findings

Contrary to the Division's suggestion, Mr. Bennett was well aware of and continually evaluated the OTS's findings throughout the year. Even before issuance of the ROE in October 2008, he had been monitoring the activity of the OTS, beginning with a preliminary exam in the spring 2008. In that exam, the OTS conducted a special review of TierOne's loans rated Special Mention that were greater than $500,000.[61] Mr. Bennett reviewed the OTS's Preliminary Comments Memorandum, which concluded that a few Special Mention loans should be downgraded, and noted that management's response included making the recommended adjustments.[62]

Mr. Bennett continued to monitor the OTS's full examination during the summer 2008. He obtained regular updates from management regarding the progress and potential findings, including with respect to increased capital ratios to be imposed, and also reviewed management's periodic written responses to the OTS. He and Mr. Aesoph brought Ms. Washek out during this period to begin her first of several credit reviews during the year.

When the ROE was issued in October 2008 indicating a CAMELS rating of 4, down from 3 in summer 2008 and 1 in 2007, Mr. Bennett, in conjunction with Mr. Aesoph, acted promptly. They scrutinized the report and engaged regulatory specialists from within KPMG to assist in

[60] Resp. Ex. 8L, L-31 Series at L-31.1 SAB 102 and Loss Factor Analysis, KPMGTO0005476-81, at 5476-78.
[61] Resp. Ex. 218, 6/18/08 Email from D. Bennett to S. Washek Re TierOne Loan Review – next week, KPMGTO-E-00107326-44, at 7342.
[62] Resp. Ex. 13M, QC-2.10 Memo from D. Kellogg to File Re Additional $6.0 Million of Loan Loss Provisions, KPMGTO0000423-24; Resp. Exs. 14A & 26, QA2 Q2 2008 Interim Completion Document, KPMGTO0000552-72, at 561; Resp. Exs. 14E and 27, QC-2 Q2 2008 ALLL Memo, KPMGTO0000859-63, at 863; Resp. Ex. 14, Q2 2008 Workpaper Binder at QC-2.2 FAS 114 Reviews Listing, KPMGTO0000869; *see also* Resp. Ex. 218, 6/18/08 Email from D. Bennett to S. Washek Re TierOne Loan Review – next week, KPMGTO-E-00107326, KPMGTO-E-00107327-44 (attaching materials related to OTS Preliminary Comment Memorandum).

evaluating its implications.[63] They also consulted with other partners within the firm, including David Butler, the Professional Practice Partner for the region and a prior SEC review partner on the TierOne engagement. The regulatory specialists ultimately concluded that, while risks were "high," TierOne did not face imminent danger of failure, in part because of the limited severity of the OTS's supervisory actions and because TierOne continued to be "well capitalized."[64] Messrs. Aesoph and Bennett also consulted with Mr. Kenney, the SEC review partner, and Ms. Washek, the credit risk specialist, to obtain their insights regarding the ROE. They also engaged Ms. Washek to perform a second credit review in October 2008 (followed by a third review in January and February 2009).

While the Division makes much of the fact that the ROE concluded TierOne's March 31, 2008 ALLL was deficient by $17 to $22 million, Mr. Bennett acknowledged and evaluated that finding. Notably, the OTS did not complete its examination until August 30, 2008. Mr. Bennett documented in a workpaper:

> When the OTS arrived for this examination subsequent to the [March 31] Form 10-Q filing, they had additional information and appraisals available to make their assessments during their loan review procedures.[65]

He documented that the OTS concluded "[m]anagement addressed our concerns by recording $28.4 million of loss provisions during the quarter ended June 30, 2008"[66] and "[t]he level of ALLL was appropriate at June 30, 2008."[67] Significantly, the OTS did *not* require TierOne to

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[63] Resp. Ex. 3E, C-1 Planning Document – Integrated, KPMGTO0003648-98, at 3657, 3659, 3664.

[64] Resp. Ex. 3C, B-3 Completion Document, KPMGTO0003477-3511, at 3507; *see also* Resp. Ex. 15E, QA-18 10/27/08 Memo from N. Anderson, through H. Kelly, & C. Stirnweis, to J. Aesoph Re TierOne Corporation / TierOne Bank, Lincoln, Nebraska, KPMGTO0001491-95.

[65] Resp. Ex. 1J, A-7 10/24/08 Memo from D. Bennett to Workpaper File Re OTS Report of Examination, KPMGTO0002565 to 2572, at 2569.

[66] Resp. Ex. 1M, A-7.2B Office of Thrift Supervision Report of Examination (June 2, 2008), KPMGTO0002593-2666, at 2612.

[67] Resp. Ex. 1M, A-7.2B Office of Thrift Supervision Report of Examination (June 2, 2008), KPMGTO0002593-2666, at 2652.

restate its March 31, 2008 financial statements for these amounts recorded in the quarter ended June 30, 2008.[68]

More broadly, Mr. Bennett observed that management undertook a variety of initiatives to improve processes and procedures in response to the OTS's findings. The initiatives included:

- Creating a new and independent IAR Department, including hiring an officer to lead the department and report directly to the Audit Committee in addition to the CEO;
- Implementing a new IAR Policy that required independent review, classification, and valuation of assets;
- Engaging a third-party, Reynolds Williams Group ("RWG"), to assist IAR in reviewing all non-homogeneous loans or loan relationships over $1 million; and
- Holding bi-weekly Problem Loan/Watch Loan Committee meetings to review all delinquent loans (including loans fewer than 90 days past due) for impairment and/or non-performance.[69]

The Division ignores all of these initiatives that followed the ROE.

Likewise, Mr. Bennett and the engagement team diligently monitored management's follow-up with the OTS. They reviewed documentation detailing management's compliance with a proposed supervisory agreement, explaining in the workpapers that "KPMG obtained this report from Internal Audit in order to track the timing and nature of m[ana]g[men]t's resolution

[68] Indeed, in a number of respects the OTS findings are inconsistent with the Division's allegations in this proceeding. *See* Mr. Bennett's Sixth (Arbitrary and Capricious), Tenth (Estoppel/Federal Regulatory Proceedings) and Eleventh (Due Process/Federal Regulatory Proceedings) Affirmative Defenses. Moreover, in internal OTS documents, the OTS acknowledged "the adequacy of ALLL has been adequately addressed by management – and greatly enhanced with quarterly SFAS No. 114 impairment templates" and concluded "[c]redit must be given to management," which "has taken appropriate and requested steps to strengthen the bank and address the problems." Resp. Ex. 151, 7/31/2008 K. Teters' Internal Memo Re Analysis Regarding Ratings, OTS-TIERONE-EF-00045064-1 to 45064-6, at 45064-2, 5.

[69] Resp. Ex. 3, Year-End 2008 Workpaper Binder (3/12) at B-8.2 An Update On The Significant Deficiency Previously Identified As Of September 30, 2008, KPMGTO0003629-36, at 3632-36; *see also* Resp. Ex. 7J, L-12 Test of Design and Operating Effectiveness Template – Integrated – Control 12-3 Problem Loan Review, KPMGTO0005117-22 (because the Problem Loan Review was relatively new and there had not been sufficient occurrences of its meetings by year-end 2008 to conclude as to the control's effectiveness, the engagement team did not rely on the Problem Loan Review in reaching its opinion regarding the effectiveness of TierOne's internal controls at December 31, 2008).

to the OTS comments."[70] They also inspected management's responses to the OTS's loan-by-loan findings, concluding the responses appeared reasonable and that "the Company is adequately responding to the OTS in a timely manner to comply with the provisions of the supervisory agreement and resolve the findings in the report of examination."[71] Then, during year-end fieldwork in February 2009, Messrs. Aesoph and Bennett reached out *directly* to the OTS to confirm their understanding of TierOne's responses to the regulators.[72] Mr. Pittman from the OTS noted in that communication "the OTS has been receiving the Company's responses to the OTS comments in a timely ma[nn]er and the submissions to date have been satisfactory," "the overall relationship between the OTS and the Company has been positive[,]... and the Company is working diligently to clear the issues noted by the OTS."[73]

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All of these efforts monitoring and evaluating the findings of the OTS reflected a genuine desire by Mr. Bennett to perform his work with due care and professional skepticism.

C. Appropriately Assisted with Testing Controls Over the ALLL

The Division's first main charge, that KPMG failed to identify and adequately test internal controls over the ALLL is premised on a contention that TierOne should have had a control for dealing *uniformly* with appraisals—for example, how often they should be updated and how and when they should be discounted if not deemed current. The Division then contends that KPMG failed to test TierOne's compliance with a supposed policy that loans be supported

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[70] *See, e.g.*, Resp. Ex. 15D, Q3 2008 QA-15 OTS Issues Tracking Report, KPMGTO0001445-53, at 1445.
[71] Resp. Ex. 3C, B-3 Completion Document – Integrated, KPMGTO0003477-3511, at 3507-08.
[72] Resp. Ex. 3C, B-3 Completion Document – Integrated, KPMGTO0003477-3511, at 3507-08; Resp. Ex. 1K, A-7.1 2/9/09 Memo from D. Bennett to Workpaper File Re Regulatory Update – Office of Thrift Supervision, KPMGTO0002573-74; Resp. Ex. 152, 2/9/09 Draft Memorandum from D. Bennett to Workpaper File Re Regulatory Update – Office of Thrift Supervision, KPMGTO-E-00065331-32 (draft workpaper reflecting Mr. Bennett's notes from 2/9/09 call with Mr. Pittman).
[73] Resp. Ex. 1K, A-7.1 2/9/09 Memo from D. Bennett to Workpaper File Re Regulatory Update – Office of Thrift Supervision, KPMGTO0002573-74, at 2573.

by appraisals issued within twelve (or six) months. These contentions misconstrue the evidence and the professional standards.

ICOFR cannot be evaluated properly without regard for what is reported. TierOne reported its FAS 114 loss estimates as a component of its ALLL. It did not report on the average age of appraisals used nor on other unobservable inputs that were part of the process. Consistent with the accounting literature that provides management with discretion to estimate fair value based on available information, TierOne's policies provided that loans be supported *either* by current appraisals *or* evaluations, that a new appraisal *may be* required depending on several factors, and that "[c]hanges in market or property conditions ... could justify an updated *evaluation*."[74] Consequently, no control with respect to current appraisals existed, nor should have been tested.[75]

TierOne did have controls to ensure that impaired loans needing to be accounted for pursuant to FAS 114 were identified and evaluated on a loan-by-loan basis and that the resulting estimates were reviewed by responsible members of management, including the Controller. The engagement team identified and sufficiently tested the key controls in this process, in addition to performing substantive procedures to evaluate *each and every* one of the FAS 114 analyses at issue in this matter.[76]

1. Identification of Key Controls

In testing ICOFR, the auditor begins at the top, with the financial statement level and entity-level controls, followed by significant accounts and disclosures and relevant assertions.

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[74] Resp. Ex. 143, TierOne Bank Lending Policy Guide, November 2007 (with revisions through April 2008), KPMGTO-E-00106098-6491, at 6163 (emphasis added).
[75] Resp. Ex. 42, Johnigan Report at 38 ("Controls designed to ensure uniformity in application are not, by definition, designed to address a series of one by one judgments" such as those relating to loan-by-loan impairment assessments.).
[76] Two of the borrowers at issue were analyzed by TierOne's Internal Audit department. The auditors reviewed these analyses for significant items.

"The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion." Resp. Ex. 50, AS No. 5 ¶¶ 21, 39.

In obtaining an understanding of the likely sources of potential misstatements and selecting controls to test, the auditor should achieve several objectives: (1) understanding the flow of transactions related to the relevant assertions; (2) identifying points within the process at which a material misstatement could arise; (3) identifying management's controls that address these potential misstatements; and (4) identifying management's controls over the prevention or timely detection of unauthorized acquisition, use, or disposition of assets that could result in a material misstatement. Resp. Ex. 50, AS No. 5 ¶¶ 34-38. Performing a "walkthrough" of a process is often the most effective means to achieve these objectives. Resp. Ex. 50, AS No. 5 ¶ 37.

The engagement team gained an understanding of likely sources of potential misstatements relating to TierOne's ALLL and loan processes through their planning and risk assessment discussed above. This informed the team's walkthrough of the loan process "of *initiating*, *authorizing*, *processing*, *recording*, and *reporting* individual transactions (or estimates) and controls including anti-fraud controls."[77] In the course of the walkthrough, the engagement team met with Mr. Kellogg (Controller), Mr. Langford (Chief Credit Officer), Mr. Frances (Special Assets Executive), Sharon Nelson (Internal Financial Reporting Specialist), Matt Brown (External Reporting Manager), Randall Wilcox (Chief Appraiser), and Dave Kilgore (Risk Assessment Officer).[78] Mr. Bennett personally reviewed both the engagement team's and

[77] Resp. Ex. 7A, LA Loans Walkthrough Memo, KPMGTO0005004-08, at 5004 (emphasis in original).
[78] Resp. Ex. 7A, LA Loans Walkthrough Memo, KPMGTO0005004-08, at 5005-08.

Internal Audit's walkthrough summaries.[79] Through this work, the engagement team identified the following key controls relating to the ALLL: (1) appraisal review; (2) management review of the ALLL; and (3) management review of impaired loans, troubled debt restructurings ("TDRs"), and non-performing loans.[80] The team also decided to test the risk rating process itself, which was essential to estimating both the FAS 5 reserve and the FAS 114 reserves within the overall ALLL.

2. Testing Key Controls

a. Appraisal Review

With respect to the appraisal review process, Mr. Bennett and the team conducted several audit procedures. They assessed the competence of Mr. Wilcox, the Chief Appraiser.[81] They sampled 40 loans over $1 million, observing the age and value of the appraisals, the identification and certification of the appraiser, evidence of the independence of the appraiser, and evidence that the appraisal was independently reviewed for reasonableness by the underwriter or loan approval officer.[82] The team observed in this work that certain appraisals were not "current" but determined that this was not a deficiency, explaining that "management estimates and documents their rationale supporting valuation in these cases," as tested elsewhere.[83]

b. Risk Rating Process

[79] Resp. Ex. 7A, LA Loans Walkthrough Memo, KPMGTO0005004-08, at 5004; Resp. Ex. 7B, LB Loan Process Walkthrough (PBC), KPMGTO0005009-28.
[80] Resp. Ex. 7C, LC Using the Work of Internal Audit - Loans, KPMGTO0005029-31, at 5030.
[81] Resp. Ex. 7G, L-8 Test of Design and Operating Effectiveness Template – Integrated - Control 7-2 Appraisal Review, KPMGTO0005086-89, at 5089.
[82] Resp. Ex. 7G, L-8 Test of Design and Operating Effectiveness Template – Integrated - Control 7-2 Appraisal Review, KPMGTO0005086-93.
[83] Resp. Ex. 7G, L-8.1, KPMGTO0005090-93, at 5093. While Internal Audit identified certain exceptions in its control testing, the engagement team did not note any exceptions in connection with its reperformance procedures. Mr. Bennett will testify that that the exceptions Internal Audit identified related to documentation missing from an appraisal file, and the engagement team followed up in its test work to obtain such documentation.

With respect to the risk rating process, the engagement team, with the assistance of the KPMG credit risk specialist, Ms. Washek, judgmentally selected forty loans for review. Over the course of two interim quarters and at year-end, they performed test work to determine whether the loans were appropriately classified, considering risk rating, interest accrual status, and impairment status.[84] The credit reviews involved evaluation of loan documentation from TierOne's files, including credit approval summaries, correspondence, development plans, appraisals, and borrower and guarantor financial information.[85] The reviews also involved regular follow-up with and inquiry of management by the engagement team regarding the facts and circumstances of each loan.

In the first instance, Ms. Washek and Ms. Burke performed the credit reviews. Ms. Washek reviewed twenty-eight lending relationships over the course of three separate reviews, focusing on higher risk markets and loan types.[86] Her review included a number of loans deemed impaired, either at the time of her review or at year-end following a review of the loan at interim. She concluded that TierOne appropriately had classified risk ratings and accrual status and agreed that the reserve methodology was appropriate.[87] Ms. Burke reviewed eight

[84] Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77; Resp. Ex. 8C, L-22.1 Loan Review Summary, KPMGTO0005280; Resp. Ex. 8D, L-22.1A KPMG Financial Risk Management External Audit Assist Credit Review Report, Interim Review June 23, 2008 As Of March 31, 2008, KPMGTO0005281-91; Resp. Ex. 8E, L-22.1B KPMG Financial Risk Management External Audit Assist Credit Review Report, Interim Review 9/30/08, KPMGTO0005292-5298; Resp. Ex. 8F, L-22.1C Q3 Loan Reviews, KPMGTO0005299-5301; Resp. Ex. 8G, L-22.1D KPMG Financial Risk Management Audit Assist Report As Of December 31, 2008, KPMGTO0005302-43.

[85] *See* Resp. Exs. 8B – 8H, L-22 series, KPMGTO0005276-5412. It is particularly unfair for the Division to criticize Mr. Bennett's work when the SEC never obtained many of the loan files reviewed by the engagement team—and then unjustifiably delayed filing the Order until almost one year after the Wells submission—thus precluding Mr. Bennett from adequately preparing a defense. *See* Mr. Bennett's Fifth (Due Process/Procedure), Twelfth (Due Process/"Age of Case" Principles) and Thirteenth (Enforcement Action Deadline) Affirmative Defenses.

[86] Resp. Ex. 8C, L-22.1 Loan Review Summary, KPMGTO0005280.

[87] *See* Resp. Exs. 8B – 8H, L-22 series, KPMGTO0005276-5472. As part of the deliberative process in the 2008 quarterly reviews and year-end audit, Mr. Bennett and Ms. Washek exchanged emails regarding various loans Ms. Washek reviewed. Their communications reflect Mr. Bennett's careful supervision and guidance regarding Ms. Washek's work. At the conclusion of each of her reviews, Ms. Washek signed-off on her reports in which she concluded that TierOne appropriately classified the risk rating and accrual status.

lending relationships, focusing on lower risk loans rated Pass.[88] These included four loan relationships selected by the engagement team and four additional loan relationships tested initially by Internal Audit, which Ms. Burke re-performed.[89] At year-end, Ms. Burke then performed roll forward procedures to update the conclusion for each loan reviewed at interim.[90] Throughout, Mr. Bennett interacted extensively with Ms. Washek and Ms. Burke and discussed their findings with Mr. Aesoph. As part of this process, Mr. Bennett personally reviewed during each interim and year-end credit review a number of loan files so that he could inspect first-hand and understand the nature of management's loan documentation.

Separately, Mr. Bennett and the engagement team reviewed the loan classification documentation prepared by Internal Audit and RWG, the third-party TierOne had engaged to assist IAR in response to the OTS findings.[91] Internal Audit had conducted fourteen loan reviews, involving ten separate borrower relationships.[92] It concluded that the classification of loans was appropriate and that TierOne had complied with FAS 5 and FAS 114.[93] RWG reviewed all non-homogeneous loans or loan relationships greater than $1 million, consisting of 144 borrowing relationships, 480 loans, and approximately $785 million in outstanding balances. This universe constituted approximately *one-third* of total net outstanding loans.[94] While RWG recommended nineteen risk rating changes, all but one involved changes of just one level, *e.g.,*

[88] Resp. Ex. 8F, L-22.1C Q3 Loan Reviews, KPMGTO0005299-5301.
[89] Resp. Ex. 8F, L-22.1C Q3 Loan Reviews, KPMGTO0005299-5301; Resp. Ex. 8H, L-22.2 IA Loan Reviews, KPMGTO0005344; Resp. Ex. 8H, at L-22.A Sub-Testing of Lunar Vail Review, KPMGTO0005345-49; Resp. Ex. 8H, at L-22.2B, Sub-Testing of St. Lawrence Homes, KPMGTO0005350-55; Resp. Ex. 8H, at L-22.2C, Sub-Testing of Gramor Acme, KPMGTO0005356-60; Resp. Ex. 8H, at L-22.2D, Sub-Testing of Danbred Ewing, KPMGTO0005361-67.
[90] Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77, at 5276.
[91] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5429.
[92] Resp. Ex. 8H, L-22.2 IA Loan Reviews, KPMGTO0005368-5412, at 5344.
[93] Resp. Ex. 8I, L-23 1/27/09 Memo from Internal Audit Department to Audit Committee, J. Laphen, G. Witkowicz, B. Quesada, G. Lundstrom, G. Furnas, and D. Langford Re Underwriting Review of Non-Homogeneous Loans (IA #09-01-07), KPMGTO0005413-16, at 5416.
[94] Resp. Ex. 3, Year-End 2008 Workpaper Binder (3/12) at B-8.2 An Update On The Significant Deficiency Previously Identified As Of September 30, 2008, KPMGTO0003629-36, at 3632; Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5429.

from 5 (Special Mention) to 6 (Substandard) and, in the aggregate, the 19 loans constituted less than 4% of the 480 loans examined.[95] Mr. Bennett personally reviewed RWG's recommended changes and, in conjunction with Mr. Aesoph, concluded the differences did *not* constitute errors.[96] TierOne adjusted twelve of the risk ratings in accordance with RWG's conclusions.[97] Mr. Bennett and the team then evaluated management's explanations for not adjusting the other ratings and discussed the issues with management. The team concluded there was no error and that the changes did not indicate a deficiency in the process given the judgment inherent in risk ratings.[98] Yet, in an exercise of professional skepticism, the engagement team conducted a sensitivity analysis regarding the reserve difference if management had made the risk rating changes on those seven loans.[99] Based on all of this work, the team concluded in their professional judgment that TierOne appropriately and timely classified loans as of December 31, 2008.[100]

c. Management Review of Impaired Loans, TDRs, Non-Performing Loans and the Overall ALLL

In addition to testing the appraisal review and risk rating processes, the KPMG team conducted audit procedures regarding management's review of the ALLL, and key inputs impacting it, through the Asset Classification Committee ("ACC"). The ACC consisted of numerous key members of management, including Gil Lundstrom (CEO), James Laphen (COO),

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[95] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5429; Resp. Ex. 8V, L-39 Series, at RWG Loan Review Summary, KPMGTO0005595-5608, at 5595.
[96] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5429.
[97] Resp. Ex. 8V, L-39 Series, RWG Loan Review Summary, KPMGTO0005595-5608, at 5595; Resp. Ex. 8V, L-39 Series, at L-39A Risk Rating Changes, KPMGTO0005609.
[98] Resp. Ex. 8V, L-39 Series, at L-39B Management Response to RWG Risk Rating Recommendations, KPMGTO0005610-11, at 5611; Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5429.
[99] Resp. Ex. 8V, L-39 Series, at L-39B Management Response to RWG Risk Rating Recommendations, KPMGTO0005610-11, at 5611. The engagement team determined that it had performed sufficient audit procedures and therefore did not rely directly on RWG's findings, despite determining that RWG was competent and independent. *See* Resp. Ex. 3I, C-6.2 Evaluation of External Experts – Integrated (RWG), KPMGTO0003735-40, at 3737, 3739.
[100] Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77, at 5277.

Eugene Witkowicz (CFO), Mr. Kellogg (Controller), Mr. Furnas (Chief Lending Officer), and Mr. Langford (Chief Credit Officer), among others.[101] Significantly, each of Messrs. Kellogg, Furnas and Langford had direct responsibility for, and intimately was involved in, determining impairment and estimating individual FAS 114 reserves.

Mr. Bennett had gained an understanding of the ACC through his review of TierOne's Lending Policy Guide and his discussions with Mr. Kellogg, the Controller.[102] The ACC was responsible for reviewing the output of processes by which problem loans were identified and classified and "for ensuring complete and accurate reserve adequacy assessment in support of the Bank's ALLL Policy."[103]

As part of their testwork, Mr. Bennett and the team conducted a variety of procedures. They assessed the knowledge of key ACC members, including Mr. Kellogg, the Controller.[104] They also determined:

- the Controller and ACC review the ALLL quarterly during the closing process;
- review of the ALLL, by the Controller and ACC, includes a quantitative analysis by loan category, using historical loss experience, classifying loans based on a grading system, and consideration of various *qualitative* loss factors;
- due to current economic conditions and trends, analysis of the ALLL includes a detailed analysis of the loans 60-90 days past due; and
- the ACC meets regularly to discuss delinquent loans and loans on the "watch list."[105]

[101] Resp. Ex. 7B, L-B Loan Process Walkthrough (PBC), KPMGTO0005009-28, at 5017-18.
[102] *See* Resp. Ex. 143, Sections from TierOne Bank Lending Policy Guide, November 2007 (with revisions through April 2008).
[103] Resp. Ex. 143, TierOne Bank Lending Policy Guide, November 2007 (with revisions through April 2008), at KPMGTO-E-00106114, 106441.
[104] Resp. Ex. 7E, L-6 Test of Design and Operating Effectiveness Template – Integrated – Management Review of Impaired Loans, TDR's, and Non Performing Loans, KPMGTO0005074-77, at 5077.
[105] Resp. Ex. 7D, L-2 Test of Design and Operating Effectiveness Template – Integrated – Control Lot 12-2 – Management Review of ALLL, KPMGTO5054-57, at 5056; *see also* Resp. Ex. 3E, C-1 Planning Document -

They determined that each quarter the ACC and Controller received, reviewed, and approved the detailed ALLL calculation, which included a loan-by-loan listing of all impaired loans with related balances, and FAS 114 reserve estimates.[106] They determined the ACC received and reviewed several detailed reports, including Delinquency Reports, Risk Rating Grading Reports, Operating Performance and Grading Summary Reports, and Classification of Assets Reports.[107] They determined the ACC also received on a weekly basis past due reports, which identified all loans greater than 59 days past due.[108] And the engagement team reviewed troubled asset reports provided to the ACC, and to the Board of Directors, to corroborate that such reports identified "potential losses, recommended charge-offs and actual losses."[109]

The engagement team determined the ACC also made judgments regarding impaired loans, TDRs, and non-performing loans.[110] Detailed loan-by-loan impairment estimates were incorporated into the ALLL schedule, which, as set forth above, the ACC reviewed and

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Integrated, KPMGTO0003648-98, at 3670 (both the ACC and Audit Committee review and approve the ALLL Schedule).

[106] Resp. Ex. 7D. L-2 Test of Design and Operating Effectiveness Template – Integrated – Control Lot 12-2 - Management Review of ALLL, KPMGTO5054-57, at 5056-57; Resp. Ex. 7D, at L-2.1 10/29/08 ACC Minutes, KPMGTO0005058-60, at 5059; Resp. Ex. 7D, at L-2.2 ALLL Analysis As Of September 30, 2008, KPMGTO0005061-66.

[107] Resp. Ex. 7E, L-6 Test of Design and Operating Effectiveness Template – Integrated – Management Review of Impaired Loans, TDR's, and Non Performing Loans, KPMGTO0005074-77, at 5075-77; *see also* Resp. Ex. 7B, L-B Loan Process Walkthrough (PBC), KPMGTO0005009-28, at 5017-18. Through its walkthrough procedures, the engagement team was familiar with the following controls that resulted in certain of the reports provided to the ACC: (1) the loan accounting systems automatically identified delinquent and non-accrual loans and produced monthly reports for consideration, capturing those loans most likely to be impaired; (2) the Credit Department prepared loan analyses based on TierOne's loan risk rating process, which analyses the Chief Credit Officer used to prepare a monthly Operating Performance and Grading Summary Report, including all loans rated "Special Mention" or worse, along with loans rated "Pass" that exhibited negative conditions; and (3) the Credit Department prepared monthly Classification of Assets Reports listing all commercial or consumer loans graded "Special Mention" and below.

[108] Resp. Ex. 7E, L-6 Test of Design and Operating Effectiveness Template – Integrated – Management Review of Impaired Loans, TDR's, and Non Performing Loans, KPMGTO0005074-77, at 5075-77.

[109] Resp. Ex. 3, Year-End 2008 Workpaper Binder (3/12) at B-8.2 An Update On The Significant Deficiency Previously Identified As Of September 30, 2008, KPMGTO0003629-36, at 3636.

[110] Resp. Ex. 2A, Management Binder (PBC) Excerpts – TierOne Loan Process Walkthrough at Management's SOX 404 Internal Control Assessment Re Lending Operations, Loan Delinquencies, Collections, ALLL, Charge-offs, and Recoveries, KPMGTO0003021-32, at 3027.

approved.[111] In advance of meetings, the ACC received credit reviews for impaired loans, which contained pertinent information relating to each loan, such as appraisal date and collateral value.[112] The ACC also reviewed reports that included "narrative and statistical discussion of . . . [r]ecommendations for non-accrual and specific reserves."[113]

Finally, Mr. Bennett personally had a number of discussions with Mr. Kellogg regarding the function of the ACC and the materials and information reviewed by it. Mr. Kellogg explained that the ACC " discusses the recent trends, status changes within the portfolios, reserve modifications, and FAS 114 impairments," which was consistent with the findings of the control test work.[114]

* * *

Based on this audit evidence, Mr. Bennett and the engagement team in their professional judgment concluded that key controls over ALLL were designed appropriately and operating effectively. Of course, if Mr. Kellogg, any other member of management, or any other employee had conveyed a lack of faith in the ACC, or in the underlying estimates within the ALLL—let

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[111] Resp. Ex. 7D. L-2 Test of Design and Operating Effectiveness Template – Integrated – Control Lot 12-2 - Management Review of ALLL, KPMGTO5054-57, at 5056-57; Resp. Ex. 7D, at L-2.1 10/29/08 ACC Minutes, KPMGTO0005058-60, at 5059; Resp. Ex. 7D, at L-2.2 ALLL Analysis As Of September 30, 2008, KPMGTO0005061-66.

[112] Resp. Ex. 142, 10/29/08 Email from J. Klinkman to J. Rogers, copying D. Kellogg Re Asset Classification Minutes October 2008, attaching TierOne ACC Minutes, KEL_D_PST_N000037637, KEL_D_PST_N000037638-1-123, KEL_D_PST_N000037639-1-83, at 37639-37-81 (materials include credit reviews for forty loans, including several impaired loans).

[113] Resp. Ex. 143, TierOne Bank Lending Policy Guide, November 2007 (with revisions through April 2008), KPMGTO-E-00106098-6491, at 6391.

[114] Resp. Ex. 7E, L-6 Test of Design and Operating Effectiveness Template – Integrated – Management Review of Impaired Loans, TDR's, and Non Performing Loans, KPMGTO0005074-77, at 5075-76; Resp. Ex. 3J, C-8 Prepared By Client (PBC) Listing, KPMGTO0003765-68, at 3766 (the engagement team requested and received ACC reports); Resp. Ex. 142, 5/26/10 Email from J. Klinkman to J. Rogers, copying D. Kellogg Re Asset Classification Minutes October 2008, attaching TierOne ACC Minutes, KEL_D_PST_N000037637, KEL_D_PST_N000037638-1-123, KEL_D_PST_N000037639-1-83 (materials include Appraisal Department Report, Asset Classification Report Changes Summary, Asset Classification Report Changes Listing, Classification of Assets Listing, Risk Rating Grade Summary Report, Operating Performance and Grading Summary Report Changes, Income Property and Commercial Real Estate Loans Operating Performance and Grading Summary Report, Commercial and Agricultural Real Estate Loans by State Listing, Memorandum from D. Langford to ACC and Board of Directors Re TierOne Bank Lending Policy Guide, Concentration Management, Portfolio Concentrations Listing, Loan Relationships $20,000,000 and Greater Listing, Charge-Offs Listings, Quarterly Delinquency Report, Construction Lending Spec/Presold Percentage Listing, ALL Analysis, Credit Reviews, and other loan-related materials).

alone fraud in the process—Mr. Bennett and the engagement team would have adjusted their audit work accordingly.[115]

D. Appropriately Assisted with Substantive Procedures Over the ALLL

The Division's second main charge, that KPMG failed to perform adequate substantive procedures on impaired loans, is similarly based on a misunderstanding of the accounting and auditing guidance regarding fair value (and appraisals) and ignores the substantial audit work performed. As discussed above, in planning the audit Mr. Bennett and the engagement team decided to perform enhanced procedures relating to the ALLL given, among other reasons, the volatile economic conditions and the OTS's findings.[116] The team in fact followed through in conducting enhanced procedures regarding the substantive test of details. And, it was in large part these enhanced procedures that caused the engagement team to devote to the 2008 interim reviews and year-end audit 2,600 hours (versus 1,700 in 2007) and Mr. Bennett personally to devote 400 hours (versus 215 in 2007).[117]

1. Overview

Mr. Bennett and the engagement team performed a variety of substantive procedures to obtain evidence supporting the reasonableness of the ALLL at December 31, 2008.
Ms. Washek's credit review work, which constituted a dual test of controls and substantive details, provided an important foundation for and part of the substantive audit procedures regarding both the FAS 5 and FAS 114 reserve estimates.

With respect to the FAS 5 reserve in particular, the largest component of the ALLL, the engagement team reviewed and tested the loss factors and other assumptions applied by

[115] *See* Mr. Bennett's Eighth (Fraud/Audit Interference) and Ninth (Estoppel/Fraud Allegations) Affirmative Defenses; *see also* Respondents' *Second* Joint Motion In Limine – For Adverse Inferences Based On Management Witnesses' Assertion Of Their Fifth Amendment Privilege Against Self-Incrimination.
[116] Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-98, at 3651-52, 3689.
[117] Resp. Ex. 197, Summary of Hours Recorded to TierOne Audits (2007-2009).

management.[118] Notably, Messrs. Aesoph and Bennett personally reviewed Internal Audit's tie out of the FAS 5 loss factors and assumptions, which included market data from third-party sources such as the Case-Schiller index and MGIC reports.[119]

The engagement team further tested the reliability of TierOne's loan reports utilized in performing audit test work and other procedures relating to the ALLL.[120] These included reports relating to impaired loans, non-performing loans, and past due loans.[121] They "tested the completeness and accuracy of these reports as part of the test work [] performed at the individual loan level at year-end."[122] Based on the results, the team concluded that loans were properly and accurately included on loan reports.[123]

The engagement team performed analytics and trend analysis relating to the ALLL (although they did not substitute those analytical procedures for substantive procedures over FAS 114 loans).[124] For example, as documented in the workpapers, the ALLL had increased from 1% to 2% of total loans in 2007 and remained at that level in 2008.[125] They evaluated TierOne's increase in non-accrual loans in light of the "declining market in general," noting the

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[118] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5431; *see also* Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69.
[119] Resp. Ex. 68, Tied-Out Allowance for Credit Losses Memo, FDICTOBBX1860339876-340171.
[120] Resp. Ex. 8J, L-30, ALLL Memo, KPMGTO0005424-31, at 5431; Resp. Ex. 8A, L Audit Program – Integrated, KPMGTO0005169-246, at 5180, 5183, 5194 (summarizing control test work related to loan data systems); Resp. Ex. 8P, L-35 Impaired Loans Memo, KPMGTO0005555; Resp. Ex. 8R, L-36 Nonperforming Loans Memo, KPMGTO0005564.
[121] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5431; Resp. Ex. 8Q, L-35A Impaired Loans, KPMGTO0005556-63 (showing tick marks indicating test work); Resp. Ex. 8S, L-36B Nonperforming Loans, KPMGTO0005566-72 (same); Resp. Ex. 8U, L-37 Series at L-37B 30-89 Days Past Due by State, KPMGTO0005579-86 (same).
[122] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5431; Resp. Ex. 8M, L-32 Series at L-32.1 FAS 114 Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-548 (showing tick marks indicating test work); Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77.
[123] Resp. Ex. 8J, L-30, ALLL Memo, KPMGTO0005424-31, at 5431.
[124] Resp. Ex. 8N, L-33 Loans/Allowance for loan losses – Yearly Analytical Review 2008, KPMGTO0005549-5551; Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5426-30; *see also* Resp. Ex. 3, Year-End Workpaper Binder (3/12) at B-5 Q4 2008 SAS 100 Analytical Procedures (Used As Final Analyticals), KPMGTO0003520-27.
[125] Resp. Ex. 8N, L-33, Loans/Allowance for loan losses – Yearly Analytical Review 2008, KPMGTO0005549-5551, at 5550.

provision for loan losses increased significantly since December 31, 2007 given increases in loan delinquencies and loan impairments.[126] They evaluated the decrease in ALLL as a percentage of non-performing loans since 2007, identifying as the primary cause

> the significant charge-off activity during 2008 as a result of the increase in impaired loans, which are assessed for additional reserves on an ongoing basis. Related allowances to impaired loans were provisioned and required charge-offs under GAAP were recorded during 2008 thus directly reducing the balance on impaired loans and stating the impaired loans at fair value.[127]

And, the engagement team analyzed fluctuations in charge-offs and reserves, noting the increases related primarily to Nevada and Florida loans for which significant provisions and charge-offs were made in 2008.[128]

2. FAS 114 Loans

With respect to individual loans evaluated for impairment, the engagement team performed enhanced substantive procedures throughout the interim reviews and at year end. At interim, they performed the following procedures:

- Judgmentally selected certain FAS 114 loans, and ensured the mathematical completeness and accuracy of the reserves and charge-offs.
- Tied in appraisals reviewed in prior quarters, and considered the appraisal date and appropriateness of any discount. For loans impaired in a prior period and for which an appraisal previously had been reviewed, reviewed the prior loan history, including the value that had been agreed to the appraisal in a prior period, to assess the basis for management's reserve estimate.[129] For any

[126] While the Division's expert refers to a workpaper that indicates market conditions had not changed during 2008, the engagement team recognized that the market had deteriorated throughout the year and enhanced its 2008 audit procedures accordingly. *See* Resp. Ex. 3E, C-1 Planning Document - Integrated, KPMGTO0003648-96, at 3651-52, 3668, 3689.
[127] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5428.
[128] Resp. Ex. 8N, L-33, Loans/Allowance for loan losses – Yearly Analytical Review 2008, KPMGTO0005549-5551, at 5550-51; *see also* Resp. Ex. 8J, L-30, ALLL Memo, KPMGTO0005424-31, at 5426-27.
[129] Resp. Ex. 13N, QC-2.11 Q1 2008 FAS 114 Analysis, KPMGTO0000425-32; Resp. Ex. 14G, QC-2.3 Q2 2008 FAS 114 Lead Sheet, KPMGTO0000870; Resp. Ex. 14H, QC-2.3A – 2.3C Q2 2008 FAS 114 Templates, KPMGTO0000871-901; Resp. Ex. 15L, QC-2.3, QC-2.3 A-B Q3 2008 FAS 114 Summary & FAS 114 Calculations, KPMGTO0001776-1809; Resp. Ex. 8M, L-32 Series at L-32.1 FAS 114 Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005484-548 (a "t" tickmark on the FAS 114 templates indicates that the engagement team tied the appraised value to the appraisal in a prior period).

newly impaired loan and/or a loan for which management obtained a new appraisal, reviewed the appraisal.

- Judgmentally selected FAS 114 templates—focused on new FAS 114 loans with significant provisions or changes, and those in certain markets, such as Nevada—and reviewed appraisals, considering appraisal date and appropriateness of any discount.

- Utilized the credit risk specialist to perform loan file reviews on certain impaired loans.

- Regularly followed up with management, including Messrs. Kellogg, Langford and Frances, to discuss certain FAS 114 loans and any outstanding questions regarding their fair value estimates.[130]

Building on the evidence obtained at interim quarters, the team at year-end performed extensive substantive procedures relating to individual loans evaluated for impairment. At December 31, 2008, management had evaluated for impairment *fifty-five* loan relationships, totaling approximately $294 million, or 10%, of the total $2.8 billion loan portfolio.[131] Although not required to do so, the engagement team reviewed *each and every* FAS 114 template prepared by management, performing procedures on each loan depending on the relevant facts and circumstances. The procedures included:

- Calculating the mathematical completeness and accuracy of the reserves and charge-offs for *all* FAS 114 loans.

- For thirteen borrower relationships consisting of thirty-seven loans, tying in appraisals reviewed by KPMG in prior quarters considering the date of the appraisal and the appropriateness of any discount to the appraisal.

[130] Resp. Ex. 13N, QC-2.11 Q1 2008 FAS 114 Analysis & FAS 114 Calculations, KPMGTO0000425-32; Resp. Ex. 14G, QC-2.3 Q2 2008 FAS 114 Lead Sheet, KPMGTO0000870; Resp. Ex. 14H, QC-2.3A – 2.3C Q2 2008 FAS 114 Templates, KPMGTO0000871-901; Resp. Ex. 15L, QC-2.2, 2.3A-C Q3 2008 FAS 114 Summary & FAS 114 Calculations, KPMGTO0001776-1809; Resp. Ex. 8M, L-32 Series at L-32A FAS 114 Summary, L-32.1 FAS 114 Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005484-548; Resp. Ex. 8M, L-32 Series at L-32 FAS 114 Procedures, KPMGTO0005482-83; *infra* n. 142.

[131] Resp. Ex. 42, Johnigan Report, Ex. A at 86. Of the fifty-five loans TierOne evaluated for impairment at December 31, 2008, management determined that nine were not impaired. For those loans, TierOne appropriately recorded FAS 5 reserves, consistent with FAS 114, EITF D-80, and SAB 102, which the engagement team documented in the workpapers. *See* Resp. Ex. 8M, L-32 Series, at L-32.A FAS 114 Summary, KPMGTO0005484; Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5427; Resp. Ex. 8L, L-31 Series at L-31.1, SAB 102 and Loss Factor Analysis, KPMGTO0005476-81, at 5476.

- Judgmentally selecting certain FAS 114 templates and reviewing additional appraisals, considering appraisal date and the appropriateness of any discount to the appraisal.

- Utilizing the credit risk specialist to perform loan file reviews on certain impaired loans as well as other loans rated Substandard but not impaired.

- Assessing the updated status of loans reviewed in prior quarters as part of loan file reviews, which included impaired loans.

- Reviewing and assessing the results of Internal Audit reviews of certain impaired loans as well as other loans rated Substandard but not impaired.

- Regularly following up with management to discuss certain FAS 114 loans and any outstanding questions regarding their fair value estimates.[132]

As a result of these expanded procedures on all loans for which FAS 114 templates had been prepared, the team concluded at the completion of field work that "there were no loans on the impaired list in excess of $1 million that KPMG was not familiar with."[133] Likewise, between the engagement team, Internal Audit and the OTS, essentially all of TierOne's Nevada portfolio had been scrutinized by year-end 2008.

In assessing the reasonableness of management's fair value collateral estimates, the engagement team evaluated the FAS 114 templates by geographic market, and considered all available indicia of value. These included not just relevant market conditions and recent appraisals, but older appraisals discounted by management along with other unobservable inputs reflecting management's own assumptions about the assumptions market participants would use

[132] Resp. Ex. 3J, C-8 TierOne Prepared By Client (PBC) Listing, KPMGTO0003765-68, at 3766 (the engagement team requested and received "FAS 114 Calculations and support for new appraisals," among other documentation relating to the ALLL); Resp. Ex. 8M, L-32 FAS 114 Procedures, KPMGTO0005482-83; Resp. Ex. 8M, L-32 Series at L-32A FAS 114 Summary and L-32.1 Series at FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005484-548; Resp. Ex. 8M, L-32 Series at L-32A FAS 114 Summary and L-32.1 Series at FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005484-548 at 5513, 5531, 5539, 5546, 5548 (noting discussions with D. Frances); Resp. Ex. 8B, L-22 Loan Reviews, KPMGTO0005276-77; Resp. Ex. 8H, L-22 Series at L-22.2 & L-22.2A-J, Internal Audit Loan Reviews, KPMGTO0005344-412; *infra* n. 142.

[133] Resp. Ex. 8P, L-35 Impaired loans memo, KPMGTO0005555; Resp. Ex. 8Q, L-35A Impaired loans, KPMGTO0005556-63.

in pricing the collateral, as provided in FAS 157.[134] The information included not only management representations, but also documentation found in the loan files as well as third-party information. The relevant facts and circumstances pertaining to the various impaired loans were not uniform but rather consisted of a multitude of factors, such as bulk sale assumptions, bankruptcy proceedings and debtor-in-possession financing, involvement of participating banks, zoning concessions, and developer reputations, among others.

There is no question that throughout its substantive procedures the engagement team reviewed numerous appraisals. In fact, they obtained appraisals for approximately two thirds of the fifty-five borrower relationships and approximately two thirds of the 186 loans that management had evaluated for impairment at December 31, 2008,[135] noting in the workpapers "Agreed to appraisal."[136] In reviewing the appraisals, they considered underlying assumptions, including comparables, and whether the appraisals were based on an "as is" or "as completed" value.

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[134] Resp. Ex. 8K, L-30A Allowance for Credit Losses Discussion of 4th Quarter 2008 Adequacy Analysis, KPMGTO0005432-69, at 5436-37, 5439, 5449-50, 5458, 5463, 5465-69.

[135] Resp. Ex. 8M, L-32 Series, at L-32.A, FAS 114 Summary, KPMGTO0005484; Resp. 8M, L-32 Series, at L-32.1, FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-5548; Resp. Ex. 13N, QC-2.1 Q1 2008 FAS 114 Analysis & FAS 114 Calculations, KPMGTO0000425-32; Resp. Ex. 14H QC-2.3A – 2.3C Q2 2008 FAS 114 Calculations, KPMGTO0000871-901; Resp. Ex. 15L QC-2.3 Series, at QC-2.3A – 2.3C, Q3 2008 FAS 114 Calculations, KPMGTO0001776-1809.

[136] Resp. Ex. 8M, L-32 Series, at L-32.1, FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-5548, at 5501 (agreed to appraisal: Leman Development loan – 10/8/08 appraisal), 5503 (agreed to appraisal: Jerry Dannenberg loan – 3/12/08 appraisal), 5506 (agreed to sample of appraisals: one of the Ashley Turner loans), 5512 (agreed to appraisal: three of the East Construction loans – 3/8/04, 5/24/06, and 7/7/07 appraisals), 5514 (agreed to several appraisals: two of the Oaktree Homes loans – 9/18/08 multiple appraisals), 5517 (agreed to appraisals: two of theWoodCastle loans – 7/08 multiple appraisals), 5518 (agreed to appraisal: Passailaigue Homes loans – 10/08 two appraisals), 5520 (agreed to appraisal: Ricardo Mejia loan – 12/3/08 appraisal), 5533 (agreed to appraisals: Integrity Homes loans – 11/5/08 two appraisals, 1/13/07 appraisal), 5534 (agreed to appraisals: BB&B Builders loans – multiple appraisals dated 2006-2007); 5540 (appraisal reviewed by S. Washek: Pueblos Partners loan – 8/1/08 appraisal), 5544 (agreed to appraisal: Carolina Concrete loans: 9/22/08 and 10/17/08 appraisals), 5545 (agreed to appraisals: one of the Meadow View loans – 5/24/02 appraisal), 5546 (agreed to appraisal: Theresa Lejohn loans – multiple appraisals dated 11/3/06 and 7/16/07), 5548 (agreed to appraisal: Camden Creek loan – 7/31/06 appraisal).

Notwithstanding the Division's hindsight challenge, the engagement team also observed that management obtained many new appraisals during 2008.[137] And they observed that management discounted both recent and older appraisals, by anywhere from a few percentage points for present-value discounts to 55% for estimated decreases in value. In each instance, the discounts derived from management's view of the unique facts and circumstances affecting the loan, as required by FAS 114 and consistent with FAS 157.[138]

Mr. Bennett was involved, directly and extensively, in the engagement team's FAS 114 assessments. At each interim period and at year-end, he promptly reviewed *all* new FAS 114 templates provided by management.[139] He provided Ms. Burke, the engagement senior, extensive, and iterative, review comments to guide her work, regularly posing questions regarding the nature of the collateral and the bases for management's estimates. He similarly was involved in providing review comments with respect to other loan-related workpapers, such

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[137] Resp. Ex. 8M, L-32 Series, at L-32.1, FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-5548, at 5485 (Clearwater Estates loan – 4/18/08 appraisal), 5488 (Grand Teton Residential loan – 4/28/08 appraisal), 5491 (Stetson Ridge loan – 11/21/08 appraisal), 5493 (Landmark Enterprise Lot 10 Deer Creek loan – 1/10/08 appraisal), 5496 (Rising Sun loan –5/5/08 appraisal), 5500 (Carrie Shaffer loan – 4/8/08 appraisal), 5501 (Leman Development loan – 10/8/08 appraisal), 5502 (Jerry Dannenberg loan – 3/12/08 appraisal), 5506 (one of the Ashley Turner loans – 1/23/08 appraisal), 5507 (Sun Valley loan – 5/08 several appraisals), 5508 (Celebrate Properties and Celebrate 45 loans – 1/08 appraisal further discounted 10%), 5510 (Equestrian Meadows loan – 12/08 appraisal), 5514 (Oaktree Homes – 9/18/08 multiple appraisals), 5516 (WoodCastle loans – 7/08 multiple appraisals), 5518 (Passailaigue Homes – 10/08 two appraisals), 5520 (Ricardo Mejia loan – 12/3/08 appraisal), 5528 (Richard Lefavor loan – 9/30/08 appraisal), 5529 (Robert Kendrick – 9/08 appraisal), 5533 (Integrity Homes – 11/5/08 two appraisals); 5539 (Blake Home Builders – six 2008 appraisals, two of which were dated 5/3/08 and another two of which were dated 6/2/08), 5540 (The Pueblos Partners loan – 8/1/08 appraisal), 5542 (Inca loan – 6/20/08 appraisal), 5543 (Blake 27 loan – 6/12/08 appraisal), 5544 (Carolina Concrete loans – 10/17/08 and 9/22/08 appraisals).

[138] Resp. Ex. 8M, L-32 Series, at L-32.1 FAS 114 – Impaired Reserves, KPMGTO0005485-5548, at 5489 (HDB – 10% discount), 5490 (Rodney Kush – 25% discount), 5493 (Landmark Enterprise – 10% discount to one loan – (notwithstanding 20% noted on template)), 5495 (McDevitt Homes – 34% discount), 5504 (Celebrate 50 – 55% discount, reflecting an increase from the 45% discount at second quarter of 2008 and a 50% discount at third quarter of 2008), 5508 (Celebrate Properties & 45 – 10% discount), 5509 (Charleston Heights – 20% discount), 5511 (Mohave Sun – 20% discount at Q3 2008 increased to 50% discount at year-end 2008 (notwithstanding 20% noted on year-end template)), 5519 (Double M Construction – 50% discount).

[139] *See* Resp. Ex. 8M, L-32 Series, at L-32.1 FAS 114 – Impaired Reserves through L-32.3 Non FAS 114 – No Impaired Reserves, KPMGTO0005485-5548; Resp. Ex. 13N, QC-2.1 Q1 2008 FAS 114 Analysis & FAS 114 Calculations, KPMGTO0000425-32; Resp. Ex. 14H QC-2.3A – 2.3C Q2 2008 FAS 114 Calculations, KPMGTO0000871-901; Resp. Ex. 15L QC-2.3 Series, at QC-2.3A – 2.3C, Q3 2008 FAS 114 Calculations, KPMGTO0001776-1809.

as ALLL Analyses, Impaired Loan Listings, Non-Performing Loan listings, and geographic loan analyses.[140] Through the course of interim review and year-end fieldwork, respectively, Mr. Bennett regularly interacted with Ms. Burke to understand the status of her follow-up and findings. In addition, Mr. Bennett, both independently and in conjunction with Ms. Burke, met with management—including each of Messrs. Kellogg, Langford and Frances—to discuss any outstanding questions regarding the individual facts and circumstances of the FAS 114 estimates.[141] After all of his review comments had been cleared, Mr. Bennett met with Mr. Aesoph to review the FAS 114 templates and discuss the fair value estimates contained therein. Again, if Mr. Kellogg, Mr. Langford or Mr. Frances—or any other member of management—had conveyed to Mr. Bennett a lack of faith in the FAS 114 estimates, the engagement team would have reacted accordingly, and likely would have reached different judgments regarding the reasonableness of the estimates.[142]

E. Appropriately Considered New Appraisals Received in 2009

The Division criticizes the engagement team purportedly for violating AU § 561, audit guidance addressing circumstances in which information comes to light after issuance of an audit opinion. The information at issue here pertains to appraisals that were first brought to the engagement team's attention in April 2009. From this technical criticism, the Division advances an argument that the engagement team failed to recognize evidence of management bias, because supposedly management withheld the appraisals. The argument is contrived.

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[140] *E.g.*, Resp. Ex. 192, 2/4/2009 Excerpts from Mgr. Review Comments – TONE 2008.xls – Manager Review Comments Loans 2, KPMGTO-E-00074555-59, at 74555-56 (providing comments on the L-35A Impaired Loans listing, L-36 Nonperforming loans memo, L-36B Nonperforming Loans listing, L-37 Loan Analysis by State, and L-37B Loan Delinquencies by State workpapers).

[141] *E.g.*, Resp. Ex. 219, 6/26/08 Email from S. Washek to D. Bennett and J. Witzel Re FAS 114 Discussion, KPMGTO-E-00110095; Resp. Ex. 169, 7/25/08 Email from B. Burke to D. Kellogg Re FAS 114 questions, WIT_J_PST_N000030469-1-2, WIT_J_PST_N000030470 (attaching list of questions); Resp. Ex. 174, 10/21/08 Email from D. Bennett to D. Frances and D. Kellogg Re 4pm meeting, FRA_D_PST_N000004473-74; Resp. Ex. 194, 2/11/09 Email chain between B. Burke and D. Frances Re Nicholson appraisal, KPMGTO-E-00272493.

[142] *See supra* footnote 116.

With respect to the audit guidance, AU § 561 provides that if an auditor becomes aware of facts after issuance of the audit report that may have affected the report, he should determine (a) whether the information is "reliable," and (b) whether the facts "existed at the date of the report." Resp. Ex. 63, AU § 561.04. If both inquiries are answered affirmatively, then additional procedures should be considered *if* the auditor's report would have been affected had the auditor known the information (*i.e.*, the information is sufficiently material to have resulted in a modification of the report).[143] There is no one-size-fits-all approach in determining whether additional procedures may be appropriate in the circumstances, and professional judgment is required in considering the criteria of AU 561. *See* Resp. Ex. 63, AU § 561.02 ("Because of the variety of conditions which might be encountered ... the specific actions to be taken in a particular case may vary somewhat in light of the circumstances.").

The updated appraisals that TierOne received in the first quarter 2009 would not have affected KPMG's 2008 integrated audit opinions, and thus AU § 561 was not triggered. Specifically, the engagement team had no reason to believe that an error existed in the December 31, 2008 financial statements. The new appraisals led to net charge-offs of $4.2 million. As explained by Ms. Johnigan, with an $84 million loan loss provision and a $93 million pretax loss, demonstrating that the new appraisals would have affected KPMG's opinions "would have been a relatively high threshold."[144]

Before even addressing impact on the audit report, however, the $4.2 million net amount would have had to have been deemed an error, which it was not. Throughout 2008, the engagement team had reviewed each of the six borrowing relationships for which TierOne received new appraisals in the first quarter 2009, and they considered the charge-offs and

[143] Resp. Ex. 42, Johnigan Report at 80-81.
[144] Resp. Ex. 42, Johnigan Report at 80.

reserves recorded in the 2009 quarters in the context of the charge-offs and reserves recorded in prior periods.[145] They also considered that a new appraisal received in 2009 reflected a $1.5 million *increase* in collateral value as compared to the value TierOne used in recording reserves at year-end 2008.[146] Given the specific facts and circumstances of the loans at issue, along with market trends, the engagement team's professional judgment was that management reasonably concluded the additional declines should be recorded in 2009.[147]

F. Appropriately Considered the Potential for Management Bias

Ignoring all of this good audit work, the Division contends that the engagement team failed to recognize management bias in the ALLL estimate. In particular, the Division's audit expert asserts management was biased in not discounting all appraisals to reflect a purported average quarterly decline in collateral values that he derived based on new appraisals received in 2008. Again, the argument is contrived.

As explained by Ms. Johnigan in her expert report, the purported 17% average quarterly decline derived by the Division's expert is a meaningless number. It represents the change in values of the appraisals—after some but not all discounts applied by TierOne—*not* the change in the estimated collateral values actually used in TierOne's loan loss estimates.[148] That is, the Division's expert fails to consider all adjustments made by management to the earlier appraisals in prior fiscal periods. When the actual loan balances after charge-offs and reserves are

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[145] Resp. Ex. 18F, QC-2 Q1 2009 ALLL Memo, KPMGTO0008090-95, at 8092; Resp. Ex. 19F, QC-2 Q2 2009 ALLL Memo, KPMGTO0008762-67, at 8764. Mr. Aesoph reviewed and signed off on these memos.

[146] *Compare* Resp. Ex. 28, FAS 114 Templates, at L-32.1 FAS 114 – Impaired Reserves, KPMGTO0005485-5520, at 5490 ($3.98 million appraised value) *with* Resp. Ex. 18J, FAS 114 Calculations, KPMGTO0008142-8157, at 8157 ($5.5 million appraised value).

[147] Bennett Tr. at 479-91; Aesoph Tr. at 447-65.

[148] The Division further contends that the decrease in unallocated reserves from mid-point in 2008 to year-end was evidence of bias. That too is unfounded. The decrease in the unallocated reserve reflected TierOne's decreasing inherent uncertainty about losses in light of its enhanced processes to evaluate loans for impairment, which included, *inter alia*, regular Problem Loan Committee meetings focused on reviewing delinquent loans, and IAR and RWG's evaluation of non-homogenous loans or loan relationships over $1 million. These processes resulted in additional reserve estimates and charge-offs for impaired loans. Therefore, one would expect a smaller unallocated reserve for losses not specifically identifiable in the loan portfolio.

considered from period to period, one readily can see the effect of the new appraisals was an average increased quarterly loan loss recognition of less than 10% of the loan balances at issue. The equivalent number for Nevada loans is 8.8%. It is illogical for the loan losses recorded based on the new appraisals received to have declined by less than 10% if the collateral values actually declined by 17%. The 17% cannot be reconciled.

What Mr. Bennett and the engagement team did observe is that TierOne throughout the year charged off significant amounts on impaired loan balances. In the aggregate, the recorded reserves and these charge-offs over the course of the year reflected an approximate 22% decrease in the value of the impaired loan portfolio—and an approximate 30% decrease in the value of the Nevada loan portfolio—both of which are consistent with the macro-economic data on which the Division's experts focus.[149]

Finally, as explained in Ms. Johnigan's expert report, the Division itself ignores counter "evidence" of management bias. This evidence was an important part of the mix of information considered by Mr. Bennett and the engagement team as they planned and executed their audit procedures. For example:

- Early in 2008, management wrote down the entirety of its goodwill—totaling $42 million—after the engagement team identified an event suggesting its potential impairment.[150]

- With respect to the HDB loan, a new appraisal received in the second quarter

[149] Remarkably, the Division's expert ignores key facts when purporting to analyze these trends. For example, he points to charge offs of $43.7 million in the first half of 2008 (excluding the TransLand charge-offs) compared to $19.5 million of charge-offs in the second half of 2008 and finds this "highly unusual." Division Ex. 211, Barron Report at 117. However, as documented in the engagement team's workpapers, the OTS disagreed with $32.1 million of FAS 114 loan loss reserves being carried on the books and instead took the position TierOne should charge-off the amounts. Resp. Ex. 1J, A-7 10/24/08 Memo from D. Bennett to Workpaper File Re OTS Report of Examination, KPMGTO0002565-2572, at 2567. Resp. Ex. 1L, A-7.2B OTS Report of Examination, KPMGTO0002593-2666, at 2612. The OTS was not disagreeing with the amount of loss recognition, just the form in which it was recorded. Correcting for this, the charge-offs in the second half of 2008 were higher than in the first half, not lower.

[150] *See* Resp. Ex. 26, QA-2.1 Year-end 2007 Completion Document – Integrated, KPMGTO0038564-594, at 38584-85; Resp. Ex. 13A, QA-2 Q1 2008 Interim Completion Document, KPMGTO0000049-70, at 60; Resp. Ex. 3, Year-End 2008 Workpaper Binder (3/12) at J-51 TierOne Bank Monthly Tax Provision, KPMGTO0000479-486, at 486.

2008 provided a higher valuation than management had used in the first quarter. However, TierOne maintained the same reserve based on factors management felt supported a higher reserve.

- In its December 2008 review of the Valley Heights loan, Internal Audit proposed that the loan be deemed impaired and an individual reserve recorded. Management then recorded a FAS 114 reserve in an amount that was higher than Internal Audit itself had calculated.[151] Notably, in an exercise of due care and professional skepticism, both Messrs. Bennett and Aesoph had extensive discussions with Jerrod Witzel, the head of Internal Audit, regarding both analyses.

- And, of the fifty-five borrower relationships evaluated under FAS 114, TierOne determined that a number were not impaired. Consequently, FAS 5 loss reserves of $6.3 million were recorded on these borrower relationships. This was substantially more than the FAS 114 loss reserves that would have been recorded if the loans were deemed impaired.

* * *

Based on *all* of the audit work as documented in the workpapers, and giving due consideration to financial statement risks and the potential for management bias, Mr. Bennett concluded in his professional judgment that the engagement team had obtained sufficient competent evidential matter to conclude that TierOne's ALLL was reasonably stated in the context of the overall financial statements.[152] Both Mr. Aesoph, the partner with ultimate responsibility for issuing an audit opinion, and Mr. Kenney, the SEC concurring review partner, concurred with Mr. Bennett's judgment.[153]

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[151] Resp. Ex. 8H, L-22.2 Series at IA Loan Reviews, KPMGTO0005344; Resp. Ex. 8H, L-22.2 Series at L-22.2F Sub Testing of Valley Heights, KPMGTO0005374-79, 5377.

[152] Resp. Ex. 3C, B-3 Completion Document – Integrated, KPMGTO0003477-3511, at 3491.

[153] Resp. Ex. 8J, L-30 ALLL Memo, KPMGTO0005424-31, at 5424; Resp. Ex. 3C, B-3 Completion Document – Integrated, KPMGTO0003477-3511, at 3477-78.

VI. CONCLUSION

Mr. Bennett is an earnest, competent auditor who complied with professional standards during the integrated audit of TierOne's 2008 financial statements. He did not ignore a significant account nor fail to perform procedures that had been planned. Rather, he worked tirelessly in planning and executing the very aspect of the audit the Division now challenges with hindsight. He consulted with specialists and obtained the sign-off of experienced partners within the firm who supervised his work. Mr. Bennett does not present a threat to the Commission's processes. Accordingly, he should not be sanctioned, and the Order should be dismissed.

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Respectfully Submitted:

Gary F. Bendinger
Kevin A. Burke
SIDLEY AUSTIN LLP
787 Seventh Avenue
New York, NY 10019
Telephone: (212) 839-5300
Facsimile: (212) 839-5599

Attorneys for Respondent Darren M. Bennett