UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

RECEIVED
DEC 11 2013
OFFICE OF THE SECRETARY

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 POST-HEARING BRIEF

December 10, 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

TABLE OF CONTENTS

Page

INTRODUCTION 1

I. OVERVIEW OF APPLICABLE ACCOUNTING PRINCIPLES AND AUDITING STANDARDS 6

II. THE DIVISION DID NOT PROVE MR. BENNETT VIOLATED PROFESSIONAL STANDARDS 9

- A. Appropriate Planning and Risk Assessments 11
  - 1. Consideration of OTS Findings 14
  - 2. Consideration of the Potential for Management Bias 16
- B. Testing Key Internal Controls Around the Sufficiency of the ALLL 18
- C. Enhanced Substantive Procedures Regarding the Reasonableness of the ALLL, Including With Respect to FAS 114 Loans 21
  - 1. Corroborating Evidence 22
  - 2. Substantial Loan Loss Recognition 24
- D. Due Consideration of Appraisals Received in 2009 30
- E. Sufficient Audit Documentation 31

III. REGARDLESS, THE EVIDENCE DOES NOT SUPPORT A SANCTION UNDER RULE 102(e) 36

- A. The Division Has a Heavy Burden 36
- B. The Division Failed to Meet its Burden, and In Fact Acknowledged Mr. Bennett's Competence 37
- C. The Division Selectively Relies on Hindsight But Insists on Ignoring the Collusive Management Fraud Designed to Deceive the Auditors 40

IV. THE DIVISION'S CONDUCT VIOLATED BASIC DUE PROCESS AND WAS FUNDAMENTALLY UNFAIR 42

CONCLUSION 45

TABLE OF AUTHORITIES

CASES **Page(s)**

Amorgianos v. AMTRAK, 303 F.3d 256 (2d Cir. 2002)....................11

Creel v. Comm'r of Internal Revenue, 419 F.3d 1135 (11th Cir. 2005)....................26

Crowley v. Chait, 322 F. Supp. 2d 530 (D.N.J. 2004)....................10, 11

Daubert v. Merrell Dow. Pharm., 509 U.S. 579 (1993)....................11

Gen. Elec. v. EPA, 53 F.3d 1324 (D.C. Cir. 1995)....................44

Hensley v. Wash. Metro. Area Transit Auth., 655 F.2d 264 (D.C. Cir. 1981)....................11

In re Dohan & Co., Release No. ID-420, 2011 SEC LEXIS 2205 (June 27, 2011)....................37

In re Hall & Meyer, Exchange Act Release No. 61162, 2009 WL 4809215 (Dec. 14, 2009)......38

In re Hall & Meyer, Release No. ID-341, 2008 WL 140722 (ALJ Jan. 15, 2008)....................38

In re H.J. Meyers & Co., File No. 3-10140, Release No. ID-211, 2002 SEC LEXIS 2075 (ALJ Aug. 9, 2002)....................11

In re Oprins & McNeeley, Release No. ID-411, 2010 SEC LEXIS 4450 (Dec. 28, 2010)...........37

In re Potts, Release No. 39126, 53 SEC Docket 187, 1997 SEC LEXIS 2005 (Sept. 24, 1997)....................36

In re Albert Glenn Yesner, CPA, File No. 3-9856, Release No. ID-184, 75 SEC Docket 220 (May 22, 2001), *available at* http://www.sec.gov/litigation/aljdec/id184rgm.htm....................11

Marrie v. SEC, 374 F.3d 1196 (D.C. Cir. 2004)....................36, 37

Nat'l Labor Relations Bd. v. MDI Commercial Servs., 175 F.3d 621 (8th Cir. 1999)....................26

Trinity Broad. v. FCC, 211 F.3d 618 (D.C. Cir. 2000)....................44

STATUTES

5 U.S.C. § 556(d)....................11

5 U.S.C. § 706 (2)(A)-(B)....................44

15 U.S.C. § 78s(c)....................43

15 U.S.C. § 7213(a)(1)....................43

15 U.S.C. § 7217(b) 43

RULES & REGULATIONS

17 C.F.R. § 201.102(e) 36

17 C.F.R. § 201.192(b) 43

Fed. R. Evid. 702 11

Fed. R. Evid. 803 32

OTHER AUTHORITIES

Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164 (Oct. 26, 1998) 36, 37, 38, 41, 43

Respondent Darren Bennett respectfully submits this Post-Hearing Brief and incorporates by reference in its entirety Respondents' Joint Proposed Findings of Fact and Conclusions of Law submitted herewith (and cited herein as "JPF ¶ __).

INTRODUCTION

The Division failed to prove Mr. Bennett committed any highly unreasonable act, or repeated unreasonable acts, sufficient to justify a Rule 102(e) finding. In fact, the Division did not prove that Mr. Bennett fell short of professional standards in any respect. The evidence instead demonstrates that he is a knowledgeable and careful auditor. In the midst of a tumultuous economic climate, he and the KPMG engagement team appropriately considered and assessed financial statement risks, identified internal controls over financial reporting, modified their audit approach and developed enhanced audit procedures that addressed risks, performed those procedures as planned, and, ultimately, concluded in their professional judgment that the audit evidence provided a reasonable basis for KPMG's 2008 TierOne integrated audit opinions.

At the commencement of the hearing, the Division set out to prove KPMG performed a "perfunctory" audit that did not include "any" testing of loans in a high risk area. (Hr'g Tr. 12:6-8; 12:18-21 (opening statement).) That theory quickly fell apart. The Division's own expert, John Barron, conceded the engagement team appropriately identified the inherently subjective allowance for lease and loan losses ("ALLL") as a significant account and planned and performed extensive procedures in this area. The Division then resorted to a different theory—that the engagement team simply "didn't go far enough" in obtaining audit evidence. (Hr'g Tr. 1127:9.) The Division failed to prove that, too, and, in any event, such a theory would not support a Rule 102(e) sanction as it can be said in any audit that more *could* have been done.

The evidence demonstrates that Mr. Bennett and the engagement team appropriately planned and performed extensive work around the ALLL, including evaluating FAS 114 fair value estimates for impaired loans. They identified and assessed financial statement risks, including that the ALLL might be insufficient and that collateral might be overvalued. They carefully considered the OTS report—consulting with other senior KPMG auditors and specialists in the process—monitored TierOne's responses to the regulatory concerns that had been raised, and prior to issuance of the audit opinions communicated directly with the OTS Field Manager in charge. Contrary to the Division's assertion, the evidence also demonstrates Messrs. Bennett and Aesoph considered the risk of management bias and observed significant evidence of a lack of such bias. Focusing on TierOne's ALLL estimation process, they identified and tested key controls and performed enhanced substantive audit procedures regarding the reasonableness of the ALLL, including the reasonableness of the FAS 114 reserves. In doing so, they engaged a KPMG credit risk specialist to assist on three separate occasions during 2008, even though it was not required. After personally completing hundreds of hours of audit work, and supervising even more work performed by others on the team, Mr. Bennett concluded that the audit met professional standards and that the team had obtained sufficient evidence to issue the audit opinions in question.

A host of experienced auditors agreed. Respondent John Aesoph, the KPMG engagement partner on the audit, along with Terence Kenney, the SEC concurring review partner, reached the same conclusion before authorizing issuance of the audit opinions. The Division makes no allegation in the Order Instituting Public Administrative Proceedings ("OIP") that Mr. Bennett concealed any information from these partners, nor could it. Indeed, Mr. Aesoph sat side-by-side with Mr. Bennett to review the fair value estimates for the FAS 114

impaired loans at issue. Sandra Johnigan, a highly regarded bank auditor and member of the Auditing Standards Board—whom the Division previously engaged as an expert in another matter—also agreed with Mr. Bennett's professional judgment. After reviewing all of the workpapers and observing all of the testimony at the hearing, she testified that the audit in its entirety, and Mr. Bennett personally, satisfied applicable professional standards. In fact, the *only* evidence presented by the Division in support of its contrary view was the testimony of Mr. Barron, who has no experience auditing banks and employed a hindsight methodology to evaluate only a limited selection of workpapers. Remarkably, Mr. Barron ignored the significant charge-offs recorded by TierOne in 2008, including with respect to Nevada impaired loans. And he formulated his opinions without reviewing a complete set of the audit workpapers or *any* of TierOne's loan files. He never opined that Mr. Bennett committed any "highly unreasonable" or even "unreasonable" act. His opinions otherwise that Mr. Bennett failed to meet professional standards should be entitled to no weight.

While the Division's pre-hearing submissions focused more extensively on testing internal controls, at the hearing the Division devoted little attention to these allegations and failed to support them with evidence. Its prior insistence that TierOne should have had a control over the timing of appraisals went unsupported, as the Division pointed to no accounting principle or auditing standard requiring that such a control exist. Indeed, TierOne was not required by accounting principles, or regulatory standards, to obtain current appraisals, much less to obtain them on any specific periodic basis. The applicable principles further make clear the bank was obligated to consider all reasonably available information in estimating fair value and impairment, including any appraisals whether "stale" or not. Regardless, the evidence shows

that the auditors appropriately tested key controls around the ALLL, including the loan classification process and the review of the ALLL by an appropriate level of management.

The Division's criticisms regarding sufficiency of the audit evidence obtained through substantive procedures around the ALLL remain unsupported. The assertion that the auditors did not corroborate management's FAS 114 reserve estimates was proven to be false, as the auditors obtained multiple forms of corroborative evidence including not just third-party appraisals but other loan file materials as well as market data. Even Mr. Barron admitted that the engagement team obtained corroborating evidence, contradicting statements to the contrary in his expert report. The evidence shows that TierOne recorded significant loan losses in 2008, including roughly 30% on Nevada impaired loans, which was not inconsistent with market data reviewed by the auditors. Respondents testified at length regarding their analyses of these losses and the impact it had on their conclusions regarding the reasonableness of the overall ALLL. Ms. Johnigan testified that Respondents' conclusions were reasonable. And even Mr. Barron conceded that the data on which these losses were calculated was contained in the audit workpapers and the calculations of losses were accurate and not inconsistent with market trends.

In the face of overwhelming evidence, the Division fell back on the argument that, even if the audit otherwise complied with professional standards, a sanction under Rule 102(e) is justified because the engagement team failed sufficiently to *document* its work. This argument, too, lacks merit, and reflects a troubling departure from the clear purpose of Rule 102(e). Documentation standards contemplate the exercise of professional judgment and, as the Division concedes (Hr'g Tr. 2284:12-15), do not require that auditors write down every fact considered or conversation had. Documentation must be sufficient to enable an experienced auditor to understand the nature, timing, extent, and results of the procedures performed, evidence

obtained, and conclusions reached. Ms. Johnigan reviewed all of the workpapers from the perspective of an experienced bank auditor and concluded that the documentation satisfied this standard. Again, the only contrary evidence presented by the Division was the testimony of Mr. Barron, who did not even bother to review all of the workpapers before opining that they were inadequate. And the criticisms presented at the hearing were trivial—for example, that the auditors neglected to include a margin notation reflecting that they had indeed performed the simple mathematical calculation yielding a 30% loan loss recognition on Nevada impaired loans. On this record, the Division failed to prove the audit documentation violated professional standards, and certainly failed to prove any documentation issue justifies depriving Mr. Bennett of his livelihood.

In short, the evidence does not come close to substantiating a Rule 102(e) sanction. The "nature, timing, and extent" of audit procedures to be performed, "interpreting the results of audit testing and evaluating audit evidence and the reasonableness of accounting estimates", and, ultimately, determining whether those procedures yield evidence sufficient to support an audit opinion, are matters entrusted to professional judgment. Such judgments, made by knowledgeable and experienced auditors in the field, and in consultation with other experienced auditors—especially in the midst of an economic crisis—should not be deemed unreasonable merely because another auditor, with hindsight (and lacking the experience of Messrs. Bennett and Aesoph), opines that he would have made a different judgment. The Division was required to prove that judgments made by Mr. Bennett not only violated professional standards but were so profoundly unreasonable that they render him incompetent to practice public accounting before the Commission. The Division made no such showing, and the charges against Mr. Bennett in the OIP should be dismissed.

I. OVERVIEW OF APPLICABLE ACCOUNTING PRINCIPLES AND AUDITING STANDARDS

TierOne was responsible for establishing effective controls over financial reporting ("ICOFR") and reporting its financial results in accordance with generally accepted accounting principles ("GAAP"). (JPF ¶¶ 39-41.) The ALLL, a single financial statement account, is an "accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date." (JPF ¶ 42.) It is not a prediction of future losses; rather, losses may be recognized only if probable and estimable as of the date of the financial statements. (JPF ¶ 44.) The ALLL has two components, an estimate under FAS 5 for non-impaired loans and an estimate under FAS 114 for individual impaired loans. (JPF ¶ 46.) The latter component is the only aspect of the financial statements put at issue by the Division here.

Under FAS 114, 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." (JPF ¶ 48.) Measuring impairment "requires judgment and estimates, and the eventual outcomes may differ from those estimates." (JPF ¶ 51.)

It is undisputed that the accounting principles applicable to the fair value estimates in this matter include both FAS 157, first effective for TierOne's 2008 fiscal year, and guidance on the application of FAS 157—*Clarifications on Fair Value Accounting*—issued by the Commission's Office of the Chief Accountant ("OCA") and the Financial Accounting Standards Board ("FASB") Staff. (JPF ¶ 479.) Under FAS 157, a fair value measurement assumes the exchange of the loan in an "orderly transaction," which "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." (JPF ¶ 55.) As clarified by the OCA and FASB, "[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." (JPF ¶¶ 58-59.) Conspicuously, Mr. Barron largely ignored in his expert report FAS 157 and its discussion of "orderly" transactions; he omitted entirely the clarification of FAS 157. (JPF ¶ 479.)[1]

As explained by Professor Chris James, a highly regarded empirical economist—whom the Division previously approved as an expert in another matter—the number of distressed sales in Nevada increased dramatically over the course of 2008. (JPF ¶¶ 148-149, 499-501.) By the fourth quarter 2008, the percentage of total sales of single-family homes constituting distressed sales was a staggering 58%, making it increasingly difficult to estimate fair value. (JPF ¶¶ 147, 149.) Likewise, during the second half of 2008, TierOne management believed—and conveyed to the auditors—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." (JPF ¶ 369; *see also id.* ¶ 371.)

Under FAS 157's hierarchy of inputs used to measure fair value, Level 3 inputs are the least precise as they are unobservable:

> [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

[1] Dr. Anjan Thakor's expert report and hearing testimony regarding market data should be accorded no weight, as they were neither relevant nor helpful. (JPF ¶¶ 509-10, 522; *see also* footnote 5 *infra*.) He provided economic analyses of market conditions on a macro basis but offered no opinions regarding TierOne's fair value estimates or the reasonableness of TierOne's ALLL. (JPF ¶¶ 515, 522; *see also id.* ¶¶ 510-11, 513.) He relied solely on market indices that include distressed sales and foreclosures. (JPF ¶¶ 503, 512, 514, 517, 522.) He also relied on data from the Lincoln Institute of Land Policy, which is not based on actual land sales at all but rather implied land sale prices derived from home sale prices. (JPF ¶ 522.) In light of the OCA and FASB clarification of FAS 157, there is no support for Dr. Thakor's opinion that a transaction is "orderly" as long as it has been exposed to market forces; indeed, even Mr. Barron did not rely on Dr. Thakor's opinions. (*See* JPF ¶¶ 515, 518-19, 520-21; *see also id.* ¶¶ 503-05, 511.) Accordingly, and for all the reasons set forth in Respondents' *First* Joint Motion *in Limine*—To Exclude the Report and Testimony of Anjan V. Thakor (Aug. 29. 2013), Mr. Bennett respectfully renews his motion to exclude Dr. Anjan Thakor's expert report and hearing testimony.

> 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.

(JPF ¶¶ 61-64.) TierOne specifically disclosed in its 2008 Form 10-K that it relied on Level 3 unobservable inputs in estimating the fair value of collateral underlying its FAS 114 loans, including "external appraisals and assessment of property values by our internal staff."[2] (JPF ¶ 118.)

Applying these accounting principles, the auditor's responsibility is to express an opinion on management's financial statements and ICOFR. (JPF ¶ 70.) The auditor's objective is to "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." (JPF ¶ 72; *see also id.* ¶ 71.) To arrive at an opinion, the auditor seeks "sufficient appropriate evidential matter to provide ... a reasonable basis for forming an opinion." (JPF ¶ 73.)

Auditors opine neither on individual loan values nor on the ALLL itself. (JPF ¶¶ 78, 85.) Rather, they evaluate the reasonableness of the ALLL "in the context of the financial statements taken as a whole." (JPF ¶¶ 78-79.) In doing so, auditors consider whether it is reasonable as "no one accounting estimate can be considered accurate with certainty." (JPF ¶¶ 84, 87.) "A difference between an estimated amount best supported by the audit evidence and the estimated

---

[2] Notwithstanding the Division's assertion that FAS 157 is a "red herring," Mr. Barron testified that he would have a "hard time" believing it is irrelevant and, to the contrary, the auditors were required to consider and apply it (which they did, as documented in the workpapers and confirmed in their hearing testimony). (JPF ¶ 119.) Likewise, while the Division dwells on the fact that Mr. Bennett never mentioned the words "FAS 157" in his investigative testimony, the Division itself never mentioned FAS 157 in its questioning of him. Throughout his investigative testimony, though, Mr. Bennett repeatedly referred to "fair value," which Ms. Johnigan testified is consistent with FAS 157 because FAS 157 "is" fair value. (JPF ¶ 61.) And, it is undisputed that in 2008 Mr. Bennett and the engagement team reviewed TierOne's disclosure in the financial statement footnotes that addressed its application of FAS 157 to FAS 114 loans. (JPF ¶ 230; *see also* JPF ¶ 119.).

amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." (JPF ¶ 84.)

Finally, the auditor exercises professional judgment in all aspects of performing an audit. (JPF ¶¶ 74-75.) 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." (JPF ¶ 74.)

II. THE DIVISION DID NOT PROVE MR. BENNETT VIOLATED PROFESSIONAL STANDARDS.

At the hearing, the Division's initial theory of the case was that the audit performed by KPMG, particularly as it related to the FAS 114 component of the ALLL, was "perfunctory". (Hr'g Tr. 25:18-22, 42:5-6 (opening statement) ("the evidence in this hearing will show ... [i]n this high-risk audit area, the audits" involved "perfunctory procedures").) The Division promised to show that the auditors did not subject the bank's most troubled loans "to *any* significant scrutiny," that they "performed *only* the *most basic* of procedures," and that they failed to "do *any* independent inspection or corroboration" of management's representations. (Hr'g Tr. 11:10-11, 12:2, 12:7-8 (opening statement) (emphases added).) Its theory quickly unraveled. As discussed further in the subsections below, un-contradicted documentary evidence and credible witness testimony establishes that Mr. Bennett and the engagement team devoted significant resources and performed extensive audit procedures, in particular, around the ALLL estimate and FAS 114 reserves. They appropriately planned the audit and assessed financial statement risks, developed procedures to address those risks, performed procedures as planned, and, ultimately, made professional judgments that the evidence obtained supported KPMG's 2008 integrated audit opinions. They documented their extensive work in nineteen binders of quarterly review and year-end audit procedures, including upwards of one thousand pages of

workpapers addressing the ALLL, each of which bears Mr. Bennett's sign-off. In a telling moment at the hearing, even Mr. Barron bristled at the Division's characterization of the audit as perfunctory. (Hr'g Tr. 1304:15-1305:14 (Barron) (after hedging, quickly retreating to say that "as an auditor and an accountant, that sounds—you know, I don't like the term, frankly.").)

The Division persists now in contending that the engagement team simply "didn't go far enough". (Hr'g Tr. 1127:9 (Barron).) Its entire case hinges on this Court's acceptance of Mr. Barron's opinions over the professional judgments of every other fact and expert witness with knowledge of the applicable professional standards and the 2008 TierOne integrated audit.[3] Mr. Barron, though, did not form his opinions by evaluating the work as if he was the auditor in the field. Rather, he performed a backwards-looking analysis focusing on a narrow slice of the audit and ignoring the significant charge-offs recorded by TierOne on impaired loans in Nevada and elsewhere. (JPF ¶¶ 469-470, 476.) He did not review all of the audit workpapers. (JPF ¶ 470.) In particular, he ignored the engagement team's work regarding the FAS 5 reserve—the largest component of TierOne's ALLL—as well as procedures regarding the overall ALLL, despite admitting that the engagement team's responsibility was to reach a conclusion on the reasonableness of the ALLL as a whole. (JPF ¶ 470.) He did not review any loan files (JPF ¶¶ 454, 483), even though he admitted that the loan files contained relevant material that might have changed his opinions (JPF ¶ 483). He did not consider any of Mr. Bennett's extensive manager review comments, even though he admitted that they probably would have assisted him in evaluating Mr. Bennett's conduct. (JPF ¶ 470.) And he did not consider how much time

[3] Beyond his lack of experience as a bank auditor, Mr. Barron appears to be biased. He acknowledged that he makes his living testifying against auditors and accounting firms. (JPF ¶ 465.) In fact, he has never testified in defense of the work performed by an auditor (JPF ¶ 464-65), and his ends-oriented selective review of the workpapers strongly suggests his work was not conducted with an open and objective mindset. *See Crowley v. Chait*, 322 F. Supp. 2d 530, 546-47 (D.N.J. 2004) (excluding portions of expert testimony as unreliable because opinions were based on review of selective and limited evidence, and other evidence ignored by expert contradicted conclusions he had reached).

Mr. Bennett devoted to the audit, or the substantial increase devoted in 2008 as compared to the prior-year engagement.[4] (JPF ¶ 470.) All of this information supports a finding that Mr. Bennett is competent to practice before the Commission. Given the deficiencies in his methodology, any contrary opinion from Mr. Barron should be accorded no weight.[5]

A. Appropriate Planning and Risk Assessments

With respect to audit planning and risk assessments, the Division in many ways admitted that Mr. Bennett and the engagement team did exactly what was expected of them under professional standards. For example, testifying on behalf of the Division, Mr. Barron readily conceded that the engagement team appropriately identified the ALLL as a significant audit area, consistent with professional standards relating to identification of risks. (JPF ¶ 176.) He conceded that the engagement team appropriately identified a high inherent risk of material misstatement in the ALLL. (JPF ¶ 177.) He conceded that the engagement team correctly identified the risk of fraud in the ALLL. (JPF ¶¶ 177, 473.) He conceded that the engagement

[4] Mr. Bennett and the engagement team devoted almost 50% more time to the 2008 engagement as compared to the 2007 engagement, much of it focused on the ALLL. The additional work was performed in response to risk assessments and reflected enhanced procedures involving, for example, monitoring of management's responses to OTS findings, credit reviews to test the loan classification process, and FAS 114 impaired loan testing. Mr. Bennett personally devoted almost 90% more time to the 2008 engagement. (JPF ¶¶ 180, 182-183, 186-188, 190-191, 200-202, 216, 317-318, 322; *see also id.* ¶¶ 161, 163.)

[5] Expert testimony should be afforded only the weight it deserves, which may vary depending on how reliable and probative the expert's analysis is, whether it is based on an adequate foundation, and whether the expert considers all important information. *See, e.g.,* 5 U.S.C. § 556(d); Fed. R. Evid. 702; *Daubert v. Merrell Dow Pharm.*, 509 U.S. 579 (1993); *In re H.J. Meyers & Co.*, File No. 3-10140, Release No. ID-211, 2002 SEC LEXIS 2075, at *142-143 (ALJ Aug. 9, 2002) (little weight accorded to opinion of expert who failed to consider factors that could have contributed to the company's financial decline); *In re Albert Glenn Yesner*, CPA, File No. 3-9856, Release No. ID-184, 75 SEC Docket 220, at n.46 (May 22, 2011), *available at* http://www.sec.gov/litigation/aljdec/id184rgm.htm (no weight to testimony of auditing expert based on "cherry-picked" numbers and unsupported assumptions and speculation); *Amorgianos v. AMTRAK*, 303 F.3d 256, 266 (2d Cir. 2002) ("[W]hen an expert opinion is based on data [or] a methodology...that...are simply inadequate to support the conclusions reached, *Daubert*...mandate[s] the exclusion of that unreliable opinion testimony."); *Crowley*, 322 F. Supp. 2d at 545-47 (barring parts of expert testimony because findings of auditor negligence were based upon limited, pre-selected record materials and thus "relied upon information that is simply too unreliable to be trusted," which "led him to draw questionable conclusions...that he might not have drawn had he properly reviewed" all of the important evidence); *Hensley v. Wash. Metro. Area Transit Auth.*, 655 F.2d 264, 270-71 (D.C. Cir. 1981) (expert opinion not entitled to substantial weight because expert lacked directly relevant experience and based opinion on limited evidence).

team appropriately identified the risk posed by deteriorating economic conditions. (JPF ¶ 177.) He conceded that the engagement team appropriately developed an understanding of that estimation process, which understanding was well-documented in the audit workpapers. (JPF ¶¶ 218-221, 223-231, 471.) And he conceded that the engagement team selected an appropriate approach to test the reasonableness of the ALLL, *i.e.*, reviewing and testing management's process to develop the estimate. (JPF ¶¶ 80-83, 306-07, 475 (Resp'ts Ex. 61, AU § 342.10(a)-(c), describes three methods of evaluating the reasonableness of an estimate, from which auditors should choose "one or a combination".).)[6]

There is no doubt that TierOne's ALLL estimation process was a central focus of the audit. (*See* JPF ¶¶ 462; *see also id.* ¶¶ 218-31, 251, 303.) The engagement team understood that the process included review and assessment of reserves for $2.1 billion of non-homogeneous loans, comprised of $1.9 billion of non-impaired loans under FAS 5 and $225 million of loans potentially impaired under FAS 114.[7] (JPF ¶¶ 120, 220-21.) The vast majority of the non-impaired loan portfolio consisted of non-homogeneous construction and land development loans. (JPF ¶ 120.) Under FAS 5, TierOne estimated reserves for these loans by grouping similar loans and then applying loss factors based on historical experience. (JPF ¶¶ 220-21.) Management periodically evaluated and assigned loans a risk rating from 1 to 9 (1 being the lowest risk, and 9

[6] Mr. Barron acknowledged that selecting an approach to audit an estimate is a matter of professional judgment, and that Mr. Bennett and the engagement team appropriately exercised professional judgment in deciding to review and test the process. (JPF ¶ 83 n. 143.) Mr. Barron also acknowledged that an auditor does not need to employ more than one of the three approaches described in AU § 342.10 (JPF ¶ 307 n. 504) and that the method chosen by Mr. Bennett and the engagement team "made the most sense" (JPF ¶¶ 83 n. 143, 307 n. 505.).

[7] TierOne's total loan portfolio, including homogenous loans, amounted to $2.8 billion at year-end 2008, and the ALLL estimate was $63.2 million. (JPF ¶ 117.) Most of the loan portfolio—$2.6 billion of the total $2.8 billion—consisted of loans not deemed impaired and accounted for under FAS 5. (JPF ¶ 117.) Estimated reserves for these non-impaired loans were $46.8 million, or 74% of the total ALLL. (JPF ¶ 117.) TierOne's net impaired loan balance at year-end 2008 totaled $170 million, *i.e.*, approximately 6% of total loans. (JPF ¶ 121.) TierOne recorded losses of $56 million on its net impaired loans through 2008. (JPF ¶ 314 n. 520.) Reserves on impaired loans were accounted for under FAS 114 and totaled $16.4 million at year-end after 2008 charge-offs of $40.4 million. (JPF ¶¶ 121, 314.)

being the highest), and applied larger loss factors to the portfolios with higher risk. (JPF ¶¶ 120, 220-221.) Significantly, neither the Division nor Mr. Barron criticizes any of the engagement team's work relating to TierOne's FAS 5 loan portfolio. (JPF ¶¶ 222, 470.)

TierOne evaluated for impairment on an individual basis those loans rated substandard or worse. (JPF ¶ 223.) For each loan deemed impaired, management generally employed "a collateral-dependent fair value model" to estimate a reserve. (JPF ¶ 224.) Loans determined not to be impaired were included in the FAS 5 portfolio and assigned a risk rating and loss factor, consistent with accounting principles. (JPF ¶¶ 50, 120, 220-221, 320.) Management documented reserve estimates for impaired loans quarterly in FAS 114 "templates", charging off the difference between the impaired loan's book value and estimated fair value and recording a reserve after considering the estimated selling costs and present value of the collateral. (JPF ¶¶ 224-25, 279.) TierOne's Special Assets Executive, David Frances, prepared the FAS 114 templates in conjunction with others such as Don Langford, the Chief Credit Officer, while the Controller, Mr. Kellogg, reviewed and approved each one of them. (JPF ¶¶ 226, 244, 279.) TierOne's Asset Classification Committee ("ACC")—comprised of eleven members including Messrs. Langford and Kellogg along with other senior executives—then reviewed and approved the ALLL. (JPF ¶¶ 282, 287, 299.)

With this understanding of the ALLL estimation process, and in light of the heightened risks, Mr. Bennett and the engagement team modified the audit approach, planning to increase—and ultimately increasing—both interim and year-end audit procedures with respect to testing the reasonableness of the ALLL. (JPF ¶ 180; *see also id.* ¶¶ 161, 163.) At the hearing, Mr. Bennett detailed these enhanced procedures, which included, *inter alia*, engaging a credit risk specialist to conduct loan reviews *three times* during the year, performing substantive procedures on *all* of

TierOne's impaired loans, and evaluating TierOne's impaired loans by state. (JPF ¶¶ 180, 191, 200, 317-318, 322, 355-56.) Notably, there was no requirement to involve a credit risk specialist, and Mr. Barron conceded that involving one was a "good example of due care." (JPF ¶¶ 191, 200.)

Acknowledging all of this good work, the Division's real criticisms of the planning and risk assessment phases of the audit are that the auditors supposedly failed to consider the OTS findings and the potential for management bias. These criticisms are misplaced.

1. Consideration of OTS Findings

Based on the evidence, there can be no doubt that Mr. Bennett and the engagement team carefully considered the OTS findings relating to TierOne in its 2008 Report of Examination (the "ROE"). Mr. Bennett promptly read the ROE, as did Mr. Aesoph. (JPF ¶ 194.) They consulted with senior KPMG partners, including Mr. Kenney, the SEC concurring review partner, and David Butler, the regional Professional Practice Partner and a prior SEC concurring review partner on the TierOne engagement, and engaged regulatory specialists to help them understand the significance of the ROE findings. (JPF ¶¶ 198-99.) They also engaged the credit risk specialist to perform a second credit review in October 2008 (followed by a third review in January/February 2009) to help assess whether any systemic issues existed with the risk rating process. (JPF ¶ 200.) They monitored management's responses to the OTS and the remediation of deficiencies identified.[8] (JPF ¶¶ 201-02.) Prior to issuing the audit opinions, they contacted Douglas Pittman—the OTS Field Manager who oversaw regulatory examinations of TierOne—to discuss the ROE and TierOne's responsiveness to the concerns raised. (JPF ¶¶ 135, 204, 206-07.) At the request of partners Aesoph, Kenney and Butler, Mr. Bennett then prepared a

[8] In particular, the engagement team reviewed multiple binders of documentation maintained by Internal Audit that detailed and tracked management's responses to the OTS findings. (JPF ¶ 201.)

workpaper summarizing the conversation and noting, *inter alia*, the OTS's receipt of timely and satisfactory responses from TierOne. (JPF ¶ 209.) Confirming Mr. Bennett's credibility, Mr. Pittman testified unequivocally at the hearing that the workpaper accurately reflected the statements he made to Messrs. Aesoph and Bennett. (JPF ¶¶ 206, 209-10.) Mr. Barron agreed that *each* of Mr. Bennett's actions in this regard reflected due professional care. (JPF ¶¶ 203, 490-91.)

The Division attempted to make much of the fact that the ROE indicated a $17-$22 million deficiency in TierOne's ALLL at March 31, 2008. As observed by Mr. Bennett and the engagement team, though, this deficiency was based on information obtained by the OTS *after* March 31, 2008. (JPF ¶ 195.) The OTS concluded that its concern had been addressed by management's recording of a $28.4 million impaired loan loss provision at June 30, 2008, at which time the regulators considered the ALLL sufficient. (JPF ¶ 197.) Moreover, the OTS did not require TierOne to restate its March 31, 2008 Thrift Financial Report ("TFR") for these amounts. (JPF ¶¶ 189, 196, 211.) Accordingly, Mr. Bennett and the engagement team did not believe the ALLL had been unreasonable at the end of the first quarter of 2008. (JPF ¶ 196.)

In evaluating the OTS's criticisms of TierOne, Mr. Bennett and the team also considered the regulators' acknowledgment of numerous positive actions taken by management to enhance its credit administration processes. (JPF ¶ 212.) For example, the ROE acknowledged, and Mr. Pittman confirmed at the hearing, that (i) management hired "experienced candidates" to enhance its credit administration department, (ii) management contracted with a special assets consultant to assist in managing the Las Vegas portfolio, (iii) credit administration reports were prepared demonstrating active oversight of the loan portfolio, and (iii) management reports were prepared to stratify the loan portfolio for analysis. (JPF ¶ 212; *see also id.* ¶¶ 215-16.) In

addition, the OTS specifically acknowledged that management had developed an appropriate template to use in evaluating FAS 114 loans for impairment, which included the identification of any loan charge-offs. (JPF ¶ 212; *see also id.* ¶ 213.) All of these efforts, among others observed by Mr. Bennett and the engagement team, demonstrated a commitment by management to improve TierOne's financial condition and reporting.

2. Consideration of the Potential for Management Bias

Similarly, the evidence demonstrates that Mr. Bennett and the engagement team appropriately considered the potential for management bias, including with respect to the ALLL estimate. They considered TierOne's increased capital requirements in the context of the ALLL and management's identification and measurement of loans for impairment. (JPF ¶ 401.)

Mr. Bennett and the engagement team observed TierOne obtaining new appraisals in different geographies throughout the year, including in the second half of 2008. (JPF ¶¶ 323, 342.) While there was only one new Nevada appraisal obtained in the second half of 2008, TierOne had obtained many new Nevada appraisals in mid-2008 (JPF ¶¶ 342, 366), which as discussed further below (Section II.C.2 *infra*) provided relevant evidence of fair value at December 31, 2008. The engagement team further understood that management, having obtained updated appraisals on a substantial portion of Nevada collateral, was disinclined to spend more resources on Nevada appraisals in the midst of the economic crisis because of a concern that updated appraisals likely would be unduly influenced by liquidation sales/prices. (JPF ¶¶ 369, 371.) As Professor James explained, management's concern appeared reasonable—appraisals were less reliable in the midst of deteriorating markets because of the spillover effect of "disorderly transactions." (JPF ¶¶ 506-07.) And, as Mr. Pittman confirmed at the hearing, the OTS never required TierOne to order new appraisals in 2008 for any impaired loan, including for any Nevada loan. (JPF ¶ 211.)

The auditors also documented their observation that TierOne recorded significant losses on impaired loans and that the losses recorded were not inconsistent with market data (*see* discussion Section II.C.2 *infra*).[9] (JPF ¶ 402.) Tellingly, the OTS did not require TierOne to restate *any* previously filed TFR. (JPF ¶¶ 189, 196, 211.) Also, the OTS did not seek to remove any member of management, or any member of the board of directors, for unsafe or unsound practices. (JPF ¶ 211.) Rather, Mr. Pittman told Messrs. Bennett and Aesoph directly in February 2009 that management was "complying with the requirements to submit additional information" and "appropriately addressing concerns raised in the ROE". (JPF ¶ 400.)

In addition to this audit evidence, Mr. Bennett and the engagement team observed significant evidence contradictory to management bias, including with respect to the ALLL estimate. For example:

- In early 2008, management wrote down $42 million of goodwill (JPF ¶ 116);
- In the second quarter 2008, upon receipt of a new appraisal indicating a higher valuation for the collateral securing the HDB loan—which could have supported a reduction in the reserve—management decided to maintain the higher reserve (JPF ¶ 403);
- In the second quarter 2008, management recorded $28 million in loan losses, which was at the *high* end of the range of reasonableness when the OTS had recommended between $17 and $22 million (JPF ¶¶ 195, 197);
- At year-end 2008, management determined that a number of the fifty-four loan relationships evaluated under FAS 114 were not impaired and recorded approximately $6.3 million in FAS 5 reserves that otherwise would not have been recorded if the loans were deemed impaired (JPF ¶ 403);
- At year-end 2008, management applied FAS 5 loss factors exceeding actual, historic losses experienced by TierOne, which again resulted in higher FAS 5 reserves (JPF ¶ 403);

[9] While Mr. Barron opined that management bias was apparent in an average quarterly net decline in appraisals of 17%—by focusing on appraisal values and ignoring fair value estimates that TierOne used in recording losses on FAS 114 loans—he significantly overstated the change. The actual effect of new appraisals increased TierOne's total loan loss recognition by less than 10%, which was not inconsistent with market trends. (JPF ¶¶ 406-07.)

- At year-end 2008, management recorded a FAS 114 reserve on the Valley Heights loan that was *higher* than the reserve recommended by Internal Audit based on its separate evaluation of the loan (JPF ¶ 403); and
- Throughout 2008, management recorded approximately 30% losses on Nevada loans when market data that included distressed sales indicated declines of approximately 33% for the same period (*see* Section II.C.2 *infra*).

All of this evidence provided support for the judgment that management had not been biased in developing the ALLL estimate, as documented in the workpapers. (JPF ¶ 411.)

B. Testing Key Internal Controls Around the Sufficiency of the ALLL.

At the hearing, the Division itself did not seem convinced of its allegations regarding internal controls. The gist of the remaining criticism in this area is that the engagement team tested only one control directly referencing the risk of collateral over-valuation and that control did not address whether appraisals for impaired loans were current. (Hr'g Tr. 1250:17-1251:2 (Barron).) The Division, therefore, contends that a supposedly necessary control was "missing" at TierOne and, in any event, that the engagement team did not sufficiently test controls around the sufficiency of the ALLL. The criticism has no merit.

Despite the Division's contention, there was no requirement that TierOne maintain a control focused on "whether appraisals were current at year-end". (Hr'g Tr. 2302:9-10 (closing argument).) Indeed, such a control would have been inappropriately myopic in light of the uncontested fact that TierOne was neither required by GAAP to obtain current appraisals for impaired loans nor to obtain updated appraisals on any periodic basis. (JPF ¶ 68.). The accounting principles make clear—and the Division concedes[10]—that the bank was to measure impairment based on all reasonably available information, which might or might not include an appraisal as Mr. Barron acknowledged. (JPF ¶ 93.) Under these principles, TierOne was

[10] The Division has admitted in separate actions against TierOne's principals that a "recent appraisal" is *not* necessary to the determination of a fair value estimate. (JPF ¶ 68 n. 119.)

required to consider whatever appraisals were available, including any purportedly "stale" appraisals. Likewise, it is undisputed that TierOne's lending policy did not contain a requirement regarding the timing of updated appraisals for impaired loans. (JPF ¶ 227.) Nor did it provide uniformity in how appraisals were to be updated or discounted. (JPF ¶¶ 227.) As Ms. Johnigan explained, it would be inconsistent with FAS 114 to have such controls given that management must evaluate impaired loans on a loan-by-loan basis taking into account unique facts and circumstances. (JPF ¶ 248 n. 423.)

Notwithstanding the Division's criticism, the evidence demonstrates Mr. Bennett and the engagement team appropriately tested internal controls around the sufficiency of the ALLL. (JPF ¶¶ 238, 302-03, 462.) This testing included TierOne's risk rating process, and it was consistent with the types of audit procedures described in AU § 342.11 (a)-(b) and (g)-(i). (JPF ¶¶ 246, 252-269.) Again, as Ms. Johnigan explained, assigning risk ratings was a critical component of management's process because, among other reasons, it enabled TierOne effectively to identify which loans to be evaluated for potential impairment. (JPF ¶¶ 246, 252.) Mr. Bennett and the team tested this control by performing loan reviews for a large sample of loans—impaired and non-impaired—many of which were performed by the credit risk specialist. (JPF ¶¶ 253, 255-57.) The testwork entailed review of documentation from TierOne's loan files, including third-party appraisals, loan analyses and credit reviews prepared by loan officers, and borrower and guarantor information. (JPF ¶ 254.) In addition to the credit risk specialist and other members of the engagement team who reviewed loan files, it is undisputed that Mr. Bennett personally reviewed a selection of these loan files in order to understand first-hand the nature of management's loan documentation. (JPF ¶¶ 260-61.) Based on these procedures and the audit evidence obtained, Mr. Bennett and the engagement team concluded that TierOne

appropriately classified its loans. (JPF ¶ 268.) And the Division does not criticize the conclusion reached. (JPF ¶ 247.)

With respect to another key control, Mr. Bennett and the engagement team properly tested the review of the ALLL by an appropriate level of management. (JPF ¶ 277.) This control specifically addressed the risk that the ALLL may be understated, including the risk that the collateral for impaired loans could be over-valued. (JPF ¶¶ 245, 280-81, 301; *see also id.* ¶¶ 299-300.) As discussed above, the ACC consisted of eleven members from various functions of management and senior management, including the Controller, who reviewed and evaluated the sufficiency of the ALLL on a regular basis. (JPF ¶¶ 282, 287, 299.) The involvement of the Controller was key given his role with respect to TierOne's financial reporting. (JPF ¶ 283; *see also id.* ¶ 279-80, 287.) Indeed, Mr. Barron acknowledged that review by the Controller from "outside the process" of developing the FAS 114 estimates "sounds like it could be an effective control". (JPF ¶ 280.) Mr. Kellogg, in the normal course of his responsibilities, already had reviewed the FAS 114 templates and thus had substantial familiarity with TierOne's impaired loans. (JPF ¶¶ 279, 283, 287.) In addition, the ACC as a committee reviewed a variety of reports containing substantial detailed information relating to individual impaired loans and the related reserves and collateral. (JPF ¶¶ 285-86, 288-296.) It is undisputed that, in testing the control, the engagement team reviewed both the ACC Meeting Minutes, which identified the reports reviewed by the ACC, as well as the reports themselves. (JPF ¶¶ 285-86, 298.) Based on this audit evidence, the team concluded that the control was both designed appropriately and operating effectively. (JPF ¶ 299-302.) Ms. Johnigan agreed. (JPF ¶¶ 303, 362; *see also id.* ¶ 304.)

C. Enhanced Substantive Procedures Regarding the Reasonableness of the ALLL, Including With Respect to FAS 114 Loans.

The evidence demonstrates Mr. Bennett and the engagement team, exercising their professional judgment, subjected TierOne's impaired loans to rigorous scrutiny through extensive substantive procedures. (JPF ¶¶ 308, 317-318, 322, 350-58, 361.) In addition to credit reviews performed on impaired loans by the credit risk specialist, Mr. Bennett decided that the team would perform a variety of substantive procedures with respect to *every* one of the fifty-four loan relationships management evaluated for impairment at year-end. (JPF ¶ 322-23; *see also id.* ¶ 324.)

Ultimately, Messrs. Bennett and Aesoph, along with Mr. Kenney—each of whom has significantly more bank auditing experience than Mr. Barron—concurred in the professional judgment that the engagement team had collected sufficient competent audit evidence regarding the reasonableness of the ALLL estimate and the FAS 114 reserves. (JPF ¶¶ 360, 396.) Significantly, prior to concurring in that judgment, Mr. Aesoph sat side-by-side with Mr. Bennett each quarter and at year-end to discuss TierOne's FAS 114 loans and to review the impairment templates. (JPF ¶ 347.) Ms. Johnigan agreed with their professional judgment, explaining that the audit evidence obtained, including third-party appraisals and other loan file documentation, provided competent and reliable audit evidence on which Mr. Bennett and the engagement team appropriately relied. (JPF ¶¶ 397, 462; *see also id.* ¶ 308.)

Again, the only evidence to the contrary offered by the Division was Mr. Barron's opinion that the audit evidence was insufficient. (Hr'g Tr. 1016:10-18 (Barron).) Yet, even Mr. Barron acknowledged that the question of what evidence is sufficient is a matter of professional judgment: "It's not, you know, a black-and-white hard line, but that's basically their judgment that they based their design of their procedures on." (JPF ¶ 75; *see also id.* ¶ 74.) Each main

contention advanced by the Division as to why the auditors purportedly failed to obtain sufficient audit evidence is without merit, as set forth in the subsections below.

1. Corroborating Evidence

The Division fervently argued that KPMG did nothing to corroborate management's representations (*e.g.*, Hr'g Tr. 12:7-8 (auditors failed "to do any independent inspection or corroboration")), but the evidence does not bear this out. Mr. Bennett and the engagement team frequently communicated with management—including Mr. Kellogg, the Controller, Mr. Frances, the Special Assets Executive, and Mr. Langford, the Chief Credit Officer—to discuss the FAS 114 loans and understand management's rationales and assumptions in estimating fair value, including with respect to discounting appraisals.[11] (JPF ¶¶ 316, 322, 330-34, 372-73; *see also id.* ¶¶ 241, 349.) While management made representations in these communications—which constitute competent audit evidence as Mr. Barron concedes (JPF ¶ 472)—the auditors did not stop there. Among the corroborating evidence obtained by the team were third-party appraisals and other materials from the loan files,[12] as well as market data used

[11] Ignoring the fact that the two-page L-32 FAS 114 procedures memo, referencing appraisals "older than a year", is a summary-level workpaper, the Division insists the workpaper undermines Mr. Bennett's testimony that the engagement team "was evaluating and inquiring [about FAS 114 loans] regardless of [the] age [of appraisals]." (Hr'g Tr. 2294:25-2295:5, 2298:25-2299:3 (closing argument).) The workpapers in total disprove the Division's contention. Several of the FAS 114 templates, in the L-32 series of workpapers, show that even with respect to 2008 appraisals the auditors made notations evidencing their conversations with TierOne management, a review of the loan file by the KPMG credit risk specialist, and the auditors' review of the appraisal itself. (JPF ¶¶ 322, 341.) Mr. Bennett's manager review comments reflect similar inquiries and audit procedures regarding 2008 appraisals. (JPF ¶¶ 325, 327-29.)

[12] In an attempt at rhetorical flourish, the Division argued in its closing that the engagement team did not actually rely on loan file materials because throughout the hearing the loan file boxes in the courtroom were "never opened". (Hr'g Tr. 2365:20-21.) Of course, in accordance with prescribed procedure, the parties had marked separately as exhibits loan file materials for use at the hearing. (JPF ¶ 338 (citing examples of evidence presented directly from loan files, including Resp'ts Exs. 77, 88, 89, and 101.) Moreover, there is no dispute that the workpapers contain hundreds of references to instances in which the engagement team reviewed materials from the loans files. (JPF ¶ 451; *see also id.* ¶ 482.) The Division's closing, therefore, does not refute the evidence showing that the auditors reviewed materials from the loan files nor does it excuse Mr. Barron's failure to do so.

to compare trends against the actual losses recorded by TierOne.[13] (JPF ¶¶ 310-12, 315, 323, 335-41, 343-45, 348, 372-74.) As Ms. Johnigan explained, all of this testwork reflects the types of procedures described in AU § 342.11 (b)-(c). (JPF ¶ 341.)

In obtaining audit evidence to understand and corroborate management's rationales and assumptions regarding FAS 114 fair value estimates, Mr. Bennett and the engagement team reviewed appraisals for approximately two-thirds of the year-end FAS 114 loan relationships, which they documented in the impairment templates with the notation "agreed to appraisal." (JPF ¶ 341.) Significantly, when Mr. Barron was confronted at the hearing with corroborating appraisal documentation from the loan files that had been obtained by the engagement team but that he previously had not reviewed, he was forced to admit his report wrongly asserted that information in the FAS 114 templates was "uncorroborated". (JPF ¶¶ 482-84; *see also id.* 343-44 (admitting that appraisals from the loan files corroborated information in the FAS 114 templates for the Streamline Construction, Leman Development, and Jerry Dannenberg loans).)

The auditors also reviewed additional documentation from the loans files to corroborate management's rationales and assumptions. These materials included a wealth of information regarding, for example, the background of the loans, the financial condition of the borrowers and guarantors, and the collateral. (JPF ¶¶ 340, 344-46.) As Mr. Bennett explained, the appraisals generally were contained within the loan files, and the audit room at TierOne was "typically filled" with "carts and carts full of loan files" available for the team to consult and review in connection with their test work. (JPF ¶¶ 336-38; *id.* ¶ 452 (based on Ms. Johnigan's bank auditing experience, "when you review appraisals, you review them in the loan files and that

---

[13] The engagement team also reviewed the loan classification conclusions reached by Reynolds Williams Group. TierOne, in response to the OTS findings, had engaged this third-party service provider to assist in reviewing 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. (JPF ¶¶ 262-66.)

would be my expectation").) In other instances, as Mr. Bennett explained, management brought to in-person meetings with the engagement team "credit files, interim credit reviews, third-party data, [and] a lot of other information that [the auditors] were able to evaluate on a loan-by-loan basis". (JPF ¶ 336.) In still other instances, management forwarded or delivered select loan file documents—rather than entire loan files—including loan analyses and credit reviews prepared by loan officers in addition to third-party appraisals. (JPF ¶ 336.)

As Mr. Bennett explained, he and other members of the engagement team often "would pick up a loan file and start working through it. . . ." (JPF ¶ 337.) For example, he reviewed the Carlos Escapa loan file, which he noted "took almost a day" to review, in order to understand the borrower-specific circumstances and provide context for evaluating the fair value estimate. (JPF ¶ 336.) He similarly reviewed the HDB loan file, noting that he "carried around" copies of documentation from the file to help him "understand how that complex loan was being accounted for." (JPF ¶ 339.)

The auditors also obtained and reviewed hundreds of pages of market data referred to in management's L-30A memorandum and discussed them with Mr. Kellogg, the Controller. (JPF ¶¶ 315-16.) Likewise, they reviewed Internal Audit's tie-out of the data and the assumptions on which management relied and, thereafter, discussed the information with Mr. Witzel, the head of Internal Audit. (JPF ¶¶ 311-12.) The information corroborated the reasonableness of management's assumptions and estimates relating to its FAS 114 reserves. (JPF ¶ 312.)

In short, the contention that the engagement team failed to obtain corroborating evidence regarding management's FAS 114 reserves was proven to be entirely wrong.

2. Substantial Loan Loss Recognition

Given that Mr. Barron ignored charge-offs, it may not be surprising that the Division's most arduous efforts at the hearing were directed at undermining the fact that TierOne recorded

substantial loan losses throughout 2008. The facts, however, were not disputed. And the Division failed to adduce evidence that the auditors were unreasonable in concluding that TierOne appropriately had reserved for impaired loans within the ALLL.

As an initial matter, it is undisputed that Mr. Bennett and the engagement team observed TierOne discounting certain appraisals in light of market conditions and other loan-specific factors in estimating the fair value of individual impaired loans. (JPF ¶ 366.) For example, as to the Rising Sun loan, they had seen TierOne adjust the loan's fair value and record additional losses of approximately $717,000 (beyond the $1.36 million reserve) in the first quarter of 2008 because management believed these losses were inherent in light of market conditions and declines observed in other Nevada loans with more recent appraisals. (JPF ¶ 485.) In the second quarter, TierOne received an updated appraisal for this loan indicating additional losses of $696,000, approximating the amount TierOne had anticipated and already recorded. (JPF ¶ 485.) As Mr. Bennett explained, this provided evidence of management's ability to consider market conditions and make appropriate fair value estimates. (JPF ¶ 485; *see also id.* ¶¶ 407-08.) Mr. Barron concurred with this assessment. (JPF ¶ 485.) The additional reserves recorded on the Rising Sun loan in the first quarter of 2008, as Mr. Barron conceded, render meaningless his contention that there was a 48% difference between the earlier appraisal and the appraisal received in the second quarter. (JPF ¶ 485.)

More broadly with respect to Nevada impaired loans, which have been the Division's focus from the outset, Mr. Bennett and the engagement team observed, in addition to all the audit procedures performed around individual loans, that TierOne's recorded losses on the Nevada portfolio were not inconsistent with market data. Specifically, TierOne had recognized $34.7 million in losses—between charge-offs and year-end reserves—on Nevada impaired loans

through 2008, amounting to approximately 30% of the gross Nevada impaired loan balance of $118 million. (JPF ¶¶ 374-75.) In a year-end conversation with Messrs. Bennett and Aesoph in which they raised questions about TierOne's discounting decisions for Nevada appraisals, Mr. Kellogg referred to this loss recognition on Nevada impaired loans and its correlation with the decline in the Case-Shiller index. (JPF ¶ 372.) The salient facts, however, are that TierOne recorded approximately 30% losses on Nevada loans in 2008, the information supporting that calculation is in the workpapers, and such losses are not inconsistent with market data—the conversation with Mr. Kellogg merely referenced those facts.[14]

Also, rather than simply accepting Mr. Kellogg's representation, Mr. Bennett and the engagement team corroborated it. In performing substantive audit procedures, including review of management's L-30A memorandum and Internal Audit's related tie-out, Mr. Bennett and the engagement team reviewed third-party market data sources such as the Case-Shiller index and MGIC reports. (JPF ¶¶ 311-12, 315-16, 374, 376.) They observed that the data, which *included* distressed or forced sales, showed a decline of approximately 33% in Nevada. (JPF ¶¶ 374, 376.) The Division does not dispute that the auditors considered this market data. (JPF ¶ 374.) Rather, it contends that the auditors did not perform a formal economic analysis to "remove distressed sales from Case-Shiller". (Hr'g Tr. 2303:6-12 (closing argument).) The Division offered no evidence that auditors are required, or expected, to perform such an analysis.

[14] Throughout the hearing, the Division attempted to cast doubt on whether this conversation with Mr. Kellogg took place. But the evidence about the conversation is undisputed and consistent with the workpapers—the engagement team documented its discussions with management about these types of loan portfolio trends in the ALLL workpapers. (JPF ¶¶ 373.) Also, despite having a cooperation agreement with Mr. Kellogg that would have required him to testify if the Division had called him (JPF ¶¶125-26), the Division elected not to call him as a witness. (JPF ¶ 127.) The inference must be that, if called, he would have corroborated the testimony of Messrs. Bennett and Aesoph. *See Nat'l Labor Relations Bd. v. MDI Commercial Servs.*, 175 F.3d 621, 628 (8th Cir. 1999) ("[Board] erred in ignoring [witness's] failure to testify."); *see also Creel v. Comm'r of Internal Revenue*, 419 F.3d 1135, 1142 (11th Cir. 2005) ("The Tax Court inferred from the Commissioner's failure to present a witness from the DOJ or U.S. Attorney's Office that any relevant testimony from such a witness would have been unfavorable to the Commissioner.").

Moreover, it is undisputed that Messrs. Aesoph and Bennett were aware that the data included distressed or forced sales and therefore indicated declines that exceeded actual declines in fair value. (JPF ¶¶ 374, 376.)

Likewise, the team had performed a state-by-state evaluation of TierOne's impaired loans to consider trends in different geographic regions, which they documented in the L-37 series workpapers. (JPF ¶¶ 355-56.) Throughout 2008, Mr. Bennett carried the impaired loan listing with him so that he "understood by state what was happening in those markets." (JPF ¶ 355.) There is no dispute that this state-by-state evaluation, along with other procedures, provided the team with an understanding that certain geographic markets, such as Nevada, faced substantial disruption and value deterioration in 2008, while others, such as Nebraska, remained relatively stable. (*See* JPF ¶¶ 355-56, 362-64.) And the year-end workpaper, which Mr. Bennett reviewed to corroborate Mr. Kellogg's representation, reflected a roughly 30% loss recognition on Nevada impaired loans. (JPF ¶ 375, 377.)[15]

As Ms. Johnigan testified, the L-37 workpaper series exemplifies the types of audit procedures described in AU § 342.11 (d)-(f). (JPF ¶ 356.) As she also testified, from the perspective of an experienced bank auditor, the 30% loss recognition was "apparent" on the face of the workpaper as well as in TierOne's 2008 financial statements. (JPF ¶ 437 (workpapers "clearly show" the 30% loss via a "really simple calculation"); *see also id.* ¶ 377.) Mr. Barron, too, agreed it was a simple calculation. (JPF ¶ 378.)

[15] At the hearing, the Division asserted that, if the Nevada losses are reduced by the $4 million of reserves recorded in 2007, the resulting 26% recognized loss is 7% less than the 33% Case-Shiller decline, resulting in a so-called $8.2 million ALLL "deficiency." The assertion is misguided. *First*, it is undisputed that a decline in the Case-Shiller index does *not* mean there is a corresponding decline in the fair value of any particular impaired loan. (JPF ¶¶ 66 , 155.) Indeed, as Mr. Barron admitted, fair value is not determined by market indices. (JPF ¶ 515.) *Second*, Case-Shiller's reported 33% decline overstates any actual declines in fair values because it does not exclude forced and distressed sales. (*See* JPF ¶ 376; *see also id.* ¶¶ 153, 517.) For similar reasons, the Division's assertion that recorded losses on portfolios in certain other states, including Arizona and Nebraska, differed from Case-Shiller data changes nothing. (JPF ¶ 66.)

There is no support for the Division's insistence that TierOne should have recorded additional losses on Nevada loans in the second half of 2008 notwithstanding the approximately 30% loss recorded overall in 2008. In fact, the Division's position is inconsistent with applicable accounting principles. (JPF ¶ 51.) As Ms. Johnigan explained, FAS 114 provides that when a loan is deemed impaired, the impairment is measured and any losses are recorded *in that period.* (JPF ¶ 477 (accounting standards require financial institutions to "first deem a loan impaired, then [] measure it, and that's when it gets recorded, and that's when the loss is recorded in the financial statements); *see also id.* ¶ 51.)

It also is not surprising that the level of losses recorded in the first half of 2008 was higher than in the second half. (JPF ¶ 197.) At June 30, 2008, the OTS required TierOne to charge off losses on impaired loans that had been provisioned for earlier in 2008, as opposed to maintaining those reserves in the ALLL. (JPF ¶ 197.) Thus, the OTS performed a review of 90% of TierOne's impaired loan portfolio, and many loans were deemed impaired and losses recorded at that time. (JPF ¶¶ 197, 267.) As confirmed in an OTS memorandum, the charge-offs recorded at June 30, 2008 were "aggressive" and reflective of the "high end" of the range of reasonable estimated losses. (JPF ¶ 214.) Nevertheless, Mr. Bennett and the engagement team observed that TierOne continued to identify loans as impaired and to record charge-offs, in the amount of $19.4 million, in the second half of 2008. (JPF ¶ 386.) And TierOne continued to establish reserves, through provision expense, including $17 million in the second half of 2008.[16] (JPF ¶ 386.) Thus, even though TierOne aggressively had recorded losses on impaired loans at

[16] The fact that a substantial portion of losses recorded in the third and fourth quarters of 2008 pertain to several, rather than many, individual loans is not in itself unreasonable given (i) the aggressive loan losses recorded in the first six months under the OTS's oversight (JPF ¶ 197), (ii) management's view that appraisals in the latter half of 2008 were more indicative of liquidation values (JPF ¶ 369; *see also id.* ¶ 371), and (iii) management's obligation to estimate FAS 114 reserves on a loan-by-loan basis according to the unique facts and circumstances of a loan (JPF ¶ 224.

June 30, 2008, it continued to evaluate loans for impairment and record new losses in the second half of the year.

Mr. Bennett and the engagement team also observed that at year-end, every Nevada impaired loan had either a 2008 appraisal or a discount applied to a prior appraisal, if not both.[17] (JPF ¶ 366.) These appraisal discounts provided evidence that TierOne was monitoring and actively addressing its impaired loan portfolio "throughout 2008 on a continual basis," including with respect to Nevada impaired loans. (JPF ¶ 369.) And regardless of discount, there is no dispute that an appraisal of any age is a valid data point to consider in estimating fair value. (JPF ¶ 383.) As Ms. Johnigan explained, appraisals are a "starting point" and should be considered in the context of a continuum over time as part of the individual loan-by-loan evaluation in estimating fair value. (JPF ¶ 383.) As both she and Mr. Bennett also testified, appraisals in mid-2008 provided reliable evidence of fair value at December 31, 2008. (JPF ¶ 383.)

In attempting to undermine the reasonableness of the losses recorded by TierOne during 2008, the Division again relied exclusively on the testimony of Mr. Barron. He suggested that TierOne's 30% loss recognition on Nevada loans was not significant because it *might* have included some unquantifiable losses that belonged in the prior year. His testimony was laden with unfounded assumptions and speculation:

> "So, again, it points out that—Because a lot of these losses are recognized early, it's really not—I mean, you can't look at it on an annual basis. You have to look at the timing of when it occurred. In other words, I'm saying if you—*if you assume* that some significant portion of these losses in the first and second quarter really were inherent in the portfolio before 2008, then they're not

[17] Carlos Escapa – March/April 2008 appraisals; Clearwater – April 2008 appraisal; Grand Teton – April 2008 appraisal; HDB – May 2008 appraisal with 10% discount; MME – April 2008 appraisal for comparable Storybook property; Pueblos Partners – August 2008 appraisal; Rising Sun – May 2008 appraisal; Stratton – January 2008 appraisal; Structured Homes – April 2008 appraisal; Celebrate 50 – 55% discount to May 2006 appraisal; Double M – 50% discount to November 2006 appraisal; Mohave Sun – 50% discount to December 2006 appraisal; Valley Heights – 34%-50% discounts to May and August 2006 appraisals. (JPF ¶¶ 342, 366, 368.)

> really all attributable to 2008; that's when they were recognized. So instead of being 30 percent, if we took those losses and moved them back into 2007, *I don't know what it would be*, but it would *probably* be less than 30 percent."

(Hr'g Tr. 1150:6-20 (Barron) (emphases added).) The Division presented *no* evidence that losses recognized in 2008 were "inherent" in the portfolio as of 2007, *no* evidence to support Mr. Barron's "assumption" that any portion of the losses recognized in the first two quarters of 2008 belonged in the prior year, *no* evidence to support his assumption that such losses inappropriately recognized in 2008 were "significant," *no* evidence of what percentage of those losses if any should be "moved" back into 2007, and *no* evidence of what percentage of losses would remain in 2008 after conducting Mr. Barron's hypothetical exercise. On its face, such speculation is inadequate to counter the uniform testimony of the other fact and expert witnesses with knowledge of the audit, and certainly is insufficient to sustain the Division's burden in this proceeding. (*See* footnote 5 *supra*.)

D. Due Consideration of Appraisals Received in 2009

The Division devoted little attention at the hearing to its allegations regarding AU § 561, presumably because it is clear the engagement team properly considered TierOne's receipt of new appraisals in 2009. AU § 561 addresses circumstances in which information comes to light following the issuance of an audit opinion. (JPF ¶ 414.) If an auditor becomes aware of facts after issuance of the audit report that may have affected the report, he should consider *if* the auditor's report would have been affected had the auditor known the information. (JPF ¶¶ 414-15.) 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. (JPF ¶¶ 416-17.)

The updated appraisals received in 2009 would not have affected KPMG's 2008 audit opinion, and so AU § 561 was not triggered. (JPF ¶¶ 419-24.) In the regular course of his work, Mr. Bennett was focused on whether financial information was being reported in the appropriate fiscal period. (JPF ¶ 418.) Likewise, he and the engagement team considered the impact of the 2009 appraisals to TierOne's 2008 financial statements and concluded they did not reveal a 2008 error. (JPF ¶¶ 419, 421-22.) They led to net charge-offs of $4.2 million. (JPF ¶ 420.) Given the $84 million loan loss provision and the $93 million pretax loss, the threshold for affecting KPMG's opinions was "relatively high." (JPF ¶ 423.) Before addressing impact on the audit report, however, the $4.2 million net amount would have to have been deemed an error, which it was not. (*See* JPF ¶ 422.) Throughout 2008, the engagement team had reviewed each of the six borrowing relationships at issue for which TierOne received new appraisals in 2009, and they considered the 2009 charge-offs and reserves recorded in the context of the prior charge-offs and reserves recorded. (JPF ¶ 422.) They also considered that one of the new appraisals received in 2009 reflected a $1.5 million *increase* in collateral value compared to the value TierOne used in recording reserves at year-end 2008. (JPF ¶ 419.) 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. (*See* JPF ¶ 421.) Ms. Johnigan agreed. (JPF ¶¶ 423.)

E. Sufficient Audit Documentation

By the close of the hearing, the Division was focused intently on the audit documentation standards. (*E.g.*, Hr'g Tr. 2279:15-18 (closing argument) (contending, "[t]here's the audit that's documented in the workpapers and there's a very different audit that has been proffered from the witness stand").) It repeatedly invoked an excerpt from AS No. 3 to argue that an "absence" of

documentation "casts doubt" on whether work was performed. (Hr'g Tr. 2284:7-11 (closing argument).) But AS No. 3 is an auditing standard, not a rule of evidence. *Cf.* Fed. R. Evid. 803(6)-(7). Nothing in AS No. 3 precludes testimonial evidence regarding the audit at issue or dictates the weight to be accorded such testimony. Accordingly, testimony from those who participated in the audit clarifies and supplements the workpapers and provides important information about the surrounding circumstances.[18]

Pursuant to AS No. 3, auditors should document their work so that an experienced auditor not involved in the audit can understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached. (JPF ¶¶ 105-07.) It is undisputed that an auditor's documentation involves the exercise of professional judgment. (JPF ¶¶ 108, 422.) It also is undisputed that an auditor is not required to document every fact considered or conversation had. (JPF ¶¶ 108-09, 432; Hr'g Tr. 2284:12-15 (closing argument) ("The Division is not suggesting that you have to document every single conversation or every single thing you look at during the audit.").) It would be impractical to do so, and thus documentation requirements take into account the time and cost of completing an audit. (JPF ¶¶ 108, 432-33.) And while the standard invokes the term "important" to qualify what must be documented, no auditor would want to describe any audit evidence as "not important". As Mr. Bennett explained at the hearing, an auditor considers *all* evidence obtained. (JPF ¶ 93.) Audit documentation, nevertheless, still requires judgment.

[18] The Division did not argue that the auditors were lying at the hearing about the work they performed, nor did it present evidence from management or anyone else to contradict their sworn testimony. The record is uncontroverted, therefore, regarding what work was performed. As discussed below, no additional documentation was required under AS No. 3. In any event, while an insufficiency of documentation would implicate AS No. 3, there is no precedent on this record for a Rule 102(e) sanction based on that alone, and no sanction would be appropriate where, as here, the evidence otherwise establishes that the work in fact was performed.

Ms. Johnigan, who reviewed all of the engagement team's workpapers from the perspective of an experienced bank auditor, concluded that the documentation satisfied AS No. 3, testifying that she understood "the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached." (JPF ¶ 438; *see also id.* ¶¶ 430-31, 441, 459, 462.) The evidence further shows that the audit workpapers are extensive. As discussed, the team documented its work in nineteen binders of quarterly review and year-end audit procedures spanning more than seven thousand pages. (JPF ¶ 435.) In particular with respect to the ALLL and FAS 114 loans, the documentation consists of dozens of quarterly and year-end workpapers and upwards of one thousand pages. (JPF ¶¶ 31, 435-436.) And documentation with respect to control work specifically around the ALLL spans approximately 130 pages. (JPF ¶ 238.) Significantly, Mr. Bennett reviewed and signed off on each of these workpapers, and Mr. Aesoph and Mr. Kenney signed-off on the key workpapers in these areas, among many others. (JPF ¶ 436; *see also id.* ¶¶ 31, 33.)

The Division is wrong when it insists that certain significant procedures were not documented. (*E.g.*, Hr'g Tr. 2298:13-15 (closing argument).) To the contrary, Mr. Bennett and the engagement team documented in the workpapers the nature of the audit procedures they were conducting and the significant findings. They did not endeavor to record every inquiry they made of management, or every loan document they reviewed. Nor were they required to do so (nor could they have done so given the enormous number of inquiries made and documents reviewed).

The purported inadequacies identified by Mr. Barron in the workpapers are, in truth, minor by any standard. There can be no question, given the Division's intense focus on the topic that in its view the best argument that the workpapers were deficient relates to the 30% loss

recognition for Nevada loans. (Hr'g Tr. 2297:23-2298:2 (closing argument) ("perhaps the most striking example is the conversation with Mr. Kellogg and the resulting calculation that the company had recognized losses equal to 30 percent of the Nevada impaired loan balance").) The criticism on this point boils down to Mr. Barron's suggestion that the auditors ought to have included an additional margin notation:

> "Well, if it were a basis for significant conclusion regarding the adequacy of the ALLL, on the balance sheet date, I would expect to see some sort of notation, like maybe in the margin, showing that the calculation equals 30 percent and appears to be reasonable based on the Case Shiller Index or whatever."

(Hr'g Tr. 1114:16-24 (Barron).) Mr. Barron conceded, however, that (i) the calculations underlying the auditor's analyses based on market data were simple, mathematically accurate and yielded a 30% figure (JPF ¶ 378); (ii) 30% was not inconsistent with the reported market decline in 2008 in Nevada (JPF ¶ 379 n. 671); and (iii) the data supporting TierOne's recognition of 30% losses on the Nevada loans was included in the workpapers. (JPF ¶ 378.) In other words, the data was documented, but Mr. Barron suggests that the auditors should have noted in the margin that they had in fact confirmed the math amounted to a 30% decline. In Ms. Johnigan's view as an experienced bank auditor, such a margin notation would be unnecessary given the percentage loss was "clear" and "apparent" on the face of the document.[19] (JPF ¶ 437.)

In other instances, the Division did not dispute that the audit work was performed or that it was documented, but quibbled with the *location* where the work was documented. (Hr'g Tr.

[19] While standing by his professional judgment that the engagement team's documentation was sufficient, Mr. Bennett acknowledged at the hearing that, under the circumstances, "it would have been nice" to have another memorandum documenting more specifically "everything we considered". (Hr'g Tr. 577:14-578:5 (Bennett).) However, AS No. 3 does not require, nor could it, that auditors anticipate at the time of an audit, and address in the workpapers, every possible theory of violation that the Division may raise in a subsequent disciplinary proceeding.

693:6-8 (Bennett) (questioning why facts were not documented in FAS 114 template workpapers, even though they were contained in L-30A workpaper); Hr'g Tr. 585:4-18 (Bennett) (questioning why facts were not documented in FAS 114 procedures workpaper, even though they were documented in impaired loan listing workpaper).) There can be no serious contention that this amounts to an "absence" of documentation.

Finally, the Division suggested on occasion, in questioning or otherwise, that the auditors should have specifically recounted in the workpapers the substance of particular conversations with TierOne management. (*E.g.,* Hr'g Tr. 583:2-6, 588:2-8.) This is an unrealistic view of auditing. Mr. Bennett spent many days on-site at TierOne and had scores of conversations with TierOne personnel, as did others on the engagement team. (*E.g.* JPF ¶¶ 9, 30, 266, 316, 330-34, 349.) It would not have been possible, nor advisable, to attempt to maintain a running record of all such conversations. It is not how auditors document their work. And it is not required by professional standards. (JPF ¶¶ 108-09, 432.) That said, the audit workpapers contain numerous references to communications with management, including with respect to the ALLL estimate and impaired loans. (*E.g.*, JPF ¶ 322, 373; *see also, e.g.*, JPF ¶¶ 241, 349.) These references are just part of the documentation, which in total convey to an experienced auditor the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached by the engagement team. (JPF ¶¶ 430-31, 438, 441, 459, 462.) And as explained below (Section III *infra*), if what is left is mere quibbling about whether certain documentation met professional standards, that is no basis for a Rule 102(e) sanction, and *never* has been.

III. REGARDLESS, THE EVIDENCE DOES NOT SUPPORT A SANCTION UNDER RULE 102(e).

Assuming *arguendo* the evidence supported a finding that Mr. Bennett fell short of professional standards in some respect—which it does not—there still is no basis for a Rule 102(e) sanction.

A. The Division Has a Heavy Burden

The Division has a heavy burden, especially where the issues alleged in the OIP were identified by the auditors, the work was done, and professional judgments were made, as now demonstrated by the evidence admitted at the hearing. Under Rule 102(e), the Division was required to prove Mr. Bennett committed either a single instance of "highly unreasonable" conduct or repeated instances of "unreasonable" conduct, each resulting in a violation of a professional standard. 17 C.F.R. § 201.102(e); *see also Marrie v. SEC*, 374 F.3d 1196, 1206-08 (D.C. Cir. 2004). Pursuant to either prong, the Division was required to prove that the conduct reflected a lack of "competence" such that Mr. Bennett's continued practice would threaten the Commission's processes. Amendment to Rule 102(e), Exchange Act Release No. 33-7593, 63 Fed. Reg. 57,164, 57,166, 57,169 (Oct. 26, 1998) ("Rule 102(e) Release"). To state what is obvious, Rule 102(e) does not encompass every professional misstep or error in judgment, even if unreasonable. *See* Rule 102(e) Release, 63 Fed. Reg. at 57,166.[20] Rather, it was designed to address conduct evidencing "an unfitness to practice" and to allow the Commission 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).

[20] The auditing standards likewise recognize that the exercise of due care does not require infallibility. (JPF ¶ 74, citing to Resp'ts Ex. 55, AU § 230.03, which applies the description of due care from Cooley on Torts to auditors, explaining "no man...undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility").

A Rule 102(e) inquiry "focus[es] on the behavior of an accountant under the facts and circumstances presented at the time. The standard does not permit judgment by hindsight, but rather compares the actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation." Rule 102(e) Release, 63 Fed. Reg. 51,768. A Rule 102(e) inquiry also is objective; findings of unreasonable conduct may not be based on "subjective second-guessing of auditing judgment calls." *Marrie*, 374 F.3d at 1206. Given this high burden, the Division has prevailed in Rule 102(e) actions against non-partner auditors only in rare cases involving egregious conduct, *e.g.*, 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, at *103-06 (Dec. 28, 2010) (failure to inform partner of relevant information); *In re Dohan & Co.*, Release No. ID-420, 2011 SEC LEXIS 2205, at *22-23, 44-45 (June 27, 2011) (failure to conduct walk-throughs of revenue system or sales cycle).

B. The Division Failed to Meet Its Burden, and In Fact Acknowledged Mr. Bennett's Competence.

The Division did not prove a violation of professional standards, much less an egregious violation sufficient to warrant a sanction under Rule 102(e). In conclusory fashion, the Division asserted that Mr. Bennett engaged in a "single instance of highly unreasonable conduct" as well as "at least multiple instances of unreasonable conduct". (Hr'g Tr. 2307:18-20 (closing argument).) But it never identified which particular act on the part of Mr. Bennett supposedly constituted highly unreasonable conduct. Nor did the Division enumerate which multiple acts supposedly constituted unreasonable conduct.[21]

[21] Given the OIP allegations and the evidence admitted at the hearing, the "repeated instances" prong of Rule 102(e) does not apply. The administrative issuing release for Rule 102(e) explains that this prong requires at least "two separate instances of unreasonable conduct occurring within one audit", for example, a failure to "gather evidential

The lack of clarity in the Division's position might stem from the Division's apparent misunderstanding of its burden. It contended at the hearing that "the only real issue in dispute is whether the auditors' conduct was negligent, whether they violated professional standards." (Hr'g Tr. 2282:25-2283:2 (closing argument).) That is *not* the only issue in dispute. The Division's burden requires additionally that it prove Mr. Bennett committed unreasonable acts such that he is deemed incompetent and a threat to the Commission's processes. This case does not come close.

By the Division's own admission, Mr. Bennett is a competent auditor who performed good audit work in many aspects of the audit. (JPF ¶ 20 ("This case is also not about whether other parts of the audit were competently done.").) It is appropriate, indeed necessary, for this Court to consider the entirety of the record, including Mr. Bennett's performance on all aspects of the audit, in determining whether he is a threat to the Commission's processes under Rule 102(e).

The record of Mr. Bennett's performance is impressive. No one disputes that he was highly qualified and well-prepared to serve as the senior manager on the 2008 TierOne integrated audit. (JPF ¶¶ 20, 471.) At the time, he had been with KPMG for eight years and had been a senior manager for one year. (JPF ¶ 18.) He had earned a Bachelor's degree in Business

---

matter *for more than two accounts*" or an erroneous certification of GAAP accounting "*in more than two accounts*". Rule 102(e) Release, 63 Fed. Reg. at 57,169. (emphases added). "By contrast, a single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute a violation of this subparagraph." *Id.* This Court has held that a fair reading of the "repeated instances" prong makes it inapplicable here, because conduct concerning one account is "one instance of conduct." *In re Hall & Meyer*, Release No. ID-341, 2008 WL 140722, at *20 (ALJ Jan. 15, 2008). While in the Division's appeal in *Hall* the Commission sought to expand the scope of the "repeated instances" prong (*In re Hall & Meyer*, Exchange Act Release No. 61162, 2009 WL 4809215, at *7 (Dec. 14, 2009) (holding "[t]here is no requirement that the two instances pertain to different accounts in that audit"), its order was not subjected to appellate review. The Division's case against Mr. Bennett concerns only *one component* of one account—the FAS 114 reserves within TierOne's December 31, 2008 ALLL. Neither the Division's allegations nor its proof comports with the Rule's plain language, and its effort to shoehorn this case into the "repeated instances" prong is an inappropriate attempt to amend Rule 102(e) by enforcement. Any Rule 102(e) sanction predicated on the "repeated instances" prong would be fundamentally unfair and in violation of Mr. Bennett's due process rights (*see* Section IV *infra*).

Administration in 1999 and a Masters of Professional Accountancy in 2000 from the University of Nebraska at Lincoln. (JPF ¶ 16.) He had completed extensive continuing professional education courses, accumulating credits far in excess of the CPE requirements, including in areas pertaining to the banking industry and the prevailing economic crisis. (JPF ¶ 19.) At the time of the 2008 audit, Mr. Bennett had four years of prior experience auditing TierOne, which provided him with cumulative knowledge regarding, among other areas, TierOne's business, operations, processes, accounting and management. (JPF ¶¶ 22.) Significantly, Mr. Barron acknowledged that Mr. Bennett was "technically competent," and he regarded Mr. Bennett as competent when he testified. (*See* JPF ¶¶ 20, 471.) He also acknowledged that Mr. Bennett was knowledgeable regarding both FAS 114 and FAS 157. (JPF ¶ 471.)

No one disputes that Mr. Bennett was diligent and hard working. He reviewed all of the 2008 audit workpapers, and his review and sign-off appears on every L-series workpaper relating to loans. (*See* JPF ¶¶ 31, 436.) He trained and closely supervised junior professionals on the team by, among other things, providing them with hundreds of detailed review comments with respect to all aspects of the quarterly and year-end audit workpapers. (JPF ¶¶ 30, 35, 324-25, 327-29.) And he worked tirelessly, increasing his hours on the 2008 TierOne engagement by approximately 90% compared to the prior year. (JPF ¶ 182.)

Mr. Barron acknowledged that Mr. Bennett performed the functions expected of a senior manager. (JPF ¶ 30.) Ms. Johnigan went further, testifying from the perspective of an experienced bank auditor that she would have wanted Mr. Bennett as the senior manager on her audit engagements. (JPF ¶ 462.) And, significantly, throughout the 2008 audit, Messrs. Aesoph and Kenney—two KPMG partners with decades of bank auditing experience—reviewed and

concurred with each significant judgment made by Mr. Bennett. (JPF ¶¶ 7, 32-33, 360, 396.) What more should be expected of Mr. Bennett under these circumstances?

C. The Division Selectively Relies on Hindsight But Insists on Ignoring the Collusive Management Fraud Designed to Deceive the Auditors.

In contravention of Rule 102(e), the Division has prosecuted this matter in several significant respects based on hindsight. At the same time, it insists that the collusive management fraud designed to deceive the auditors, which was discovered only after the 2008 audit, must be ignored. The Division cannot have it both ways.

Beyond engaging Mr. Barron to perform a backwards-looking analysis focusing on a narrow piece of the audit in an effort to substantiate allegations already made in the OIP (*see* Section II *supra*), the Division at the hearing repeatedly sought to introduce evidence that *did not exist* at the time of the 2008 audit. For example, the Division introduced documents and elicited testimony regarding the failure of TierOne in June 2010, apparently hoping to convey the notion that the bank's eventual failure was somehow obvious during the 2008 audit. The Division questioned the OTS Field Manager Mr. Pittman on the subject. Conspicuously, the Division in its examination was not interested in Mr. Pittman's views of TierOne's prospects at the time of the 2008 audit. (Hr'g Tr. 1426:7-1427:5 (Pittman).) However, as Mr. Pittman revealed on cross-examination, he did *not* believe in early 2009 that TierOne was going to fail if management took the steps necessary to correct the problems identified (JPF ¶ 205) and he *did* believe—as he conveyed to Messrs. Aesoph and Bennett in their February 2009 telephone conversation—"management was working to address the issues that had been identified". (JPF ¶ 206.) He also believed the only thing that could change TierOne's financial condition was either an improvement in the real estate market or additional capital, and Mr. Pittman, just like everyone else in the midst of the economic crisis, did not know what was going to happen in the real estate

markets in the future. (JPF ¶ 205.) The Division's attempt to change the focus of this proceeding from the "facts and circumstances presented [to Mr. Bennett] at the time", and instead to rely on the stark light of hindsight, is impermissible. *See* Rule 102(e) Release, 63 Fed. Reg. 51,768.

The Division then insists that the Court ignore the collusive fraud perpetrated by TierOne management against the auditors, which the Commission itself alleged in separate federal court actions and admitted in its opening at the hearing was not in dispute. (JPF ¶¶ 122-24, 442-43.) While Mr. Bennett is not seeking a "pass", this fraud targeted Mr. Bennett with respect to the very financial statement account at issue here and corrupted the audit process. A Rule 102(e) sanction under these circumstances would be fundamentally unfair.

It is undisputed that management's fraud was designed to "deceive" the auditors, as alleged by the Commission itself in separate federal court actions. (JPF ¶¶ 122-24, 442-43.) That fraud involved, *inter alia*, management's failure to disclose to KPMG certain appraisals and other information relating to its assumptions regarding information underlying TierOne's ALLL estimate and FAS 114 reserves. (*See* JPF ¶¶ 443, 449; *see also id.* ¶ 444-47.) Management also failed to disclose that it had concerns regarding the sufficiency of the ALLL itself, including the sufficiency of certain FAS 114 reserves, and that the FAS 114 fair value estimates were not the result of a good faith consensus process. (*See* JPF ¶ 443; *see also id.* ¶ 444-47.)

It is undisputed that Mr. Bennett had no knowledge of management's fraud. (JPF ¶ 447.) The Division also does not contend that he should have discovered it.[22] Indeed, even the OTS

---

[22] The professional standards acknowledge that "[b]ecause of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement." (JPF ¶ 73.) In addition, such an audit may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements. (JPF ¶ 73.) The subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting 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

regulators did not detect it at the time. (JPF ¶ 447.) But there can be no question that the fraud corrupted the audit process, impacting the persuasiveness of audit evidence and making an already difficult job in the midst of an economic crisis that much more difficult for Mr. Bennett. (*See* JPF ¶ 448.)

The Division's insistence that a collusive management fraud to deceive Mr. Bennett is irrelevant, in the course of a proceeding to determine whether Mr. Bennett purportedly is an "incorrigibly inept professional", is truly remarkable.

IV. THE DIVISION'S CONDUCT VIOLATED BASIC DUE PROCESS AND WAS FUNDAMENTALLY UNFAIR.

Finally, the manner in which the Division conducted an incomplete investigation and has sought to prove its case with novel interpretations of the professional standards violated basic due process, and was fundamentally unfair.

First, through the course of its years-long investigation, the Division did not obtain loan files for two-thirds (38 of 54) of the FAS 114 loan relationships at year-end 2008. (JPF ¶ 453.) This, despite the fact that the engagement team documented in its 2008 workpapers hundreds of instances in which the team referred to materials from the loan files. (JPF ¶ 451; *see also id.* ¶ 482.) Without acknowledging the irony, the Division continues to insist the auditors failed to obtain corroborating evidence in performing audit procedures around those very same loans. Even Mr. Barron acknowledged that, if he had been the auditor in the field, going to the loan files would have been one of the first places he would have looked for corroboration. (JPF ¶ 482; *see also id.* ¶ 452.) And, as discussed (*see* Section II.C.1 *supra*), at the hearing Mr. Barron was forced to admit that information in management's FAS 114 templates was in fact

---

Oversight Board. (JPF ¶ 73.) Finally, collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. (JPF ¶ 73.)

corroborated by loan file documents obtained by the engagement team. The Division's failure to obtain all of the loan files for the loans it put at issue deprived Mr. Bennett of a fair opportunity to prepare and present his defense.

Second, the Division's interpretations of accounting principles and auditing standards in this proceeding contravene accepted interpretations within the profession. For example, the Division suggested at the hearing with respect to applicable accounting principles, and FAS 157 in particular, that fair value measurements ought *not* exclude the impact of disorderly sales in times of economic turmoil. (Hr'g Tr. 2363:19–24 (closing argument).) As explained in Section I *supra*, this interpretation flies in the face of applicable accounting principles and related guidance jointly issued by the OCA and FASB.

In addition, the Division suggested that the engagement team here should be deemed responsible for "auditing" each of TierOne's FAS 114 reserve estimates. (Hr'g Tr. 1027:23–1028:3 (Barron); 2286:6–7 (closing argument).) This too contravenes applicable auditing standards, which make clear that auditors express an opinion on the presentation of the financial statements taken as a whole. (*See* JPF ¶¶ 70, 72; *see also id.* ¶¶ 78-79, 85-87, 97, 234, 462(c).) As Ms. Johnigan explained, if the Division's contentions were correct, the "standards would have to be rewritten." (JPF ¶ 78.)

A Rule 102(e) finding based on the Division's novel interpretations therefore would amount to impermissible rulemaking by enforcement.[23] *See* Rule 102(e) Release, 63 Fed. Reg. at 57,166 ("The Commission does not seek to use Rule 102(e)(1)(ii) to establish new standards for

[23] The Public Company Accounting Oversight Board is vested with authority to promulgate standards governing the auditing profession. 15 U.S.C. § 7213(a)(1). The role of the Commission is limited. *See* 15 U.S.C. § 7217(b)(3); *id.* § 7217(b)(5) (incorporating the requirements of 15 U.S.C. § 78s(c)). The FASB and the OCA are vested with authority to promulgate accounting principles. Any accounting "rule or regulation of general application other than an interpretive rule" must be accompanied by standard notice-and-comment procedures subject to certain exceptions that are not applicable here. 17 C.F.R. § 201.192(b).

the accounting profession. The rule itself imposes no new professional standards on accountants."). Not only would this contravene Rule 102(e), it would violate Mr. Bennett's due process rights by depriving him of notice of the standards against which his professional conduct is to be judged.[24] 5 U.S.C. § 706 (2)(A)-(B) (agency decision may not be "arbitrary," "capricious," or "contrary to constitutional right"); *Gen. Elec. v. EPA*, 53 F.3d 1324, 1330-34 (D.C. Cir. 1995) (reversing agency's finding of liability and related fine where agency interpretation was "so far from a reasonable person's understanding of the regulations that they could not have fairly informed [company] of the agency's perspective" and therefore violated company's due process rights); *Trinity Broad. v. FCC*, 211 F.3d 618, 628-29, 632 (D.C. Cir. 2000) (vacating FCC's denial of license renewal application where regulated entity was not on notice of agency's interpretation of regulation and where FCC statements led the regulated entity to believe it had complied with the regulation; notice standard focuses on whether a "regulated party acting in good faith would be able to identify, with ascertainable certainty, the standards with which the agency expects parties to conform").

* * *

The fact of the matter is Darren Bennett was stunned by this proceeding. He had an exemplary career as a public auditor and was considered by KPMG partners to be a "great" senior manager in the Omaha office—a tireless worker, an effective communicator, and a strong mentor and supervisor. (JPF ¶ 24.) He worked on major engagements and was given significant

---

[24] *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. In a similar vein, the Commission has taken contrary positions in related enforcement actions regarding contentions made here. Specifically, notwithstanding the Division's fixation with current appraisals here, the Commission alleged in its federal court actions against TierOne's principals that a "recent appraisal" is *not* necessary to the appropriate determination of fair value. *See* Resp'ts Ex. 234, Complaint ¶ 28, *SEC v. Lundstrom et al.*, No. 12-cv-00343 (D. Neb. Sept. 25, 2012); Resp'ts 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. A Rule 102(e) sanction predicated on an assertion the Division itself has contradicted would be fundamentally unfair.

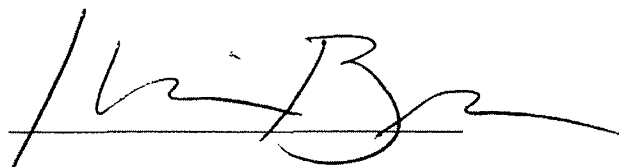
responsibilities. (*See* JPF ¶¶ 23, 32.) He advanced as expected. (JPF ¶ 18.) By all accounts, he went the extra mile. He had every reason to go home to his family content in the knowledge that he was doing his job well. Then, following the collapse of the entire banking sector and the demise of TierOne, the Division commenced its investigation. Mr. Bennett answered the call, voluntarily appearing for many days of investigative testimony to help the Division understand TierOne, its accounting, and the audit. At the end of that process, however, the Division insisted on second-guessing Mr. Bennett's professional judgments, based on hindsight and an incomplete investigation. Its assertion that Mr. Bennett is incompetent and a threat to the Commission's processes could not be farther from the truth. Punishing an auditor after he appropriately identified risks and reacted by *increasing* the audit work performed is a precarious and dispiriting message to send to public auditors. Mr. Bennett is a credit to the profession, and he should be permitted to continue practicing before the Commission.

CONCLUSION

For the foregoing reasons, this public administrative proceeding against Mr. Bennett should be dismissed.

Dated: December 10, 2013

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