UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15168

In the Matter of

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

Respondents.

RESPONDENT JOHN J. AESOPH'S POST-HEARING BRIEF

December 10, 2013

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

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

TABLE OF CONTENTS
(continued)

EXHIBITS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

TABLE OF AUTHORITIES
(continued)

I.
INTRODUCTION AND OVERVIEW

The hearing in this matter demonstrated that the 2008 audit of the year-end financial statements and internal controls over financial reporting of TierOne Corporation ("TierOne" or "Bank")—which Respondent John Aesoph and his audit team planned and executed—fully satisfied all applicable professional standards. This Post-Hearing Brief on behalf of Mr. Aesoph, together with Respondents' Joint Proposed Findings of Fact and Conclusions of Law ("J.P.F."), explains why the evidence refutes the Division's charges under Commission Rule of Practice 102(e) and requires dismissal of this case.

Faced with fatal flaws in its allegations, the Division seeks to ignore GAAP, rewrite accounting principles, and disregard irrefutable evidence. This case has come down to a handful of impaired loans in Nevada, TierOne's most distressed lending market and the state with the highest foreclosure rate in the nation in 2008. At the hearing, the Division conceded that Mr. Aesoph and his team identified every risk relevant to TierOne's allowance for loan and lease losses ("ALLL"), including the risks presented by the unprecedented economic conditions. The Division's insistence that the auditors performed only "perfunctory" procedures and failed to identify *even one* control addressing the risk that loan loss estimates were understated rang hollow in the face of all of the evidence adduced during the nine-day hearing. Ultimately, the *evidence* simply did not support the Division's *allegations*, leaving the Division no choice but to ignore the facts and mischaracterize critical audit and accounting standards.

That effort started during opening statements, when the Division argued that a critical piece of accounting literature—Statement of Financial Accounting Standards No. 157 ("FAS 157"), which governs the concept of fair value—was a "red herring." (Tr. 42:18–25 (Division's Counsel).) Using that label to describe *any* relevant professional guidance would be improper in any proceeding in which the careers of two independent auditors are at stake. But here, applying that label to FAS 157 is particularly troubling. Without an understanding of fair value under FAS 157, TierOne's loan loss estimates—and, more importantly, the auditors' assessment of them—cannot be accurately or fairly evaluated. The Division's own audit expert, John Barron, recognized that Mr. Aesoph was "required to take recognition of" FAS 157 during the 2008 audit and could not even *mention* the word "fair value" without implicating that guidance. (Tr. 2242:16–43:11 (Barron).)

The Division did not stop at trying to erase FAS 157. It also attempted to foist on Mr. Aesoph a new interpretation of fair value that did not exist in 2008 and does not exist today, using testimony from a non-CPA who is unqualified to opine on the meaning of Generally Accepted Accounting Principles. Indeed, the Division's proffered interpretation—that fair value must be based on raw market data, even data heavily influenced by a rising tide of distressed sales—contradicted not only the view of every accountant who testified at the hearing (including Mr. Barron) but also was flatly at odds with guidance that the Commission and the Financial Accounting Standards Board issued just a few months before year-end 2008. *See infra* section III.B.

These were just some of the ways in which the Division ignored or misapplied relevant accounting and auditing standards. Beyond these multiple errors in the Division's treatment of the professional guidance, it disregarded the bulk of the audit work Mr. Aesoph and his team planned and performed, instead isolating just two pages of the work papers and then claiming they prove the audit was "perfunctory." The Division further alleged that these cherry-picked portions of the work papers prove a violation of AS No. 3, the auditing standard governing documentation. When the relevant work papers are examined in full, and in the context of the audit work as a whole, as they must be, they prove just the opposite—that the audit complied with every applicable professional standard, including those governing documentation. *See infra* sections II.A–D.

The quarterly and year-end 2008 work papers—spanning some 19 binders and over 7,000 pages, all of which are now part of the record (J.P.F. ¶ 435)—reveal a carefully planned audit that amassed a significant amount of evidence on TierOne's ALLL and internal controls. Apparently the Division did not bother to review all of that work, and neither did its auditing expert, Mr. Barron, who openly admitted that he focused on only a subset of the audit documentation and formed no opinion at all about the audit work over the largest portion of TierOne's loan portfolio. (J.P.F. ¶ 470.) In contrast, Ms. Sandra Johnigan—a 40-year veteran of the accounting profession, a member of the AICPA Auditing Standards Board, and an expert the Commission itself has retained—reviewed *all* of the work papers before forming her expert opinion that Mr. Aesoph and his team satisfied every applicable professional standard.

The work papers explicitly reference still more documentation that the Division simply ignored: TierOne's comprehensive loan files,[1] a number of which the auditors reviewed to corroborate a sample of TierOne's impaired loan loss estimates.[2] Despite the admitted relevance

---

[1] The Division asserted in its closing argument that the Court "never saw evidence in the loan files," because those loan files, which occupied some 49 banker's boxes, were "not once opened" at the hearing. (Tr. 2365:17–25 (Division's Counsel).) The Division is mistaken. *See infra* section III.A.1.

[2] The work papers document over 200 instances in which the audit team reviewed TierOne's loan files. (J.P.F. ¶ 451.) This includes the 36 loans reviewed by the KPMG credit risk specialist and an audit staff member, 7 loans examined as part of the auditors' walkthrough procedures, hundreds of loans reviewed as part of various controls procedures, and numerous instances of the auditors reviewing loan files to corroborate numbers used in the Bank's FAS 114 calculations. (*See id.*) The Division's suggestion in closing argument that the auditors did not, in fact, review the loan files is therefore wrong. (Tr. 2364:2–11 (Division's Counsel).)

of the loan files, the Division allowed Mr. Barron to form his opinions without examining *a single one*. (J.P.F. ¶ 483.) Yet, when confronted with portions of the loan files during cross examination, Mr. Barron admitted that opinions included in his expert report were wrong. *See infra* section III.A.1. And it was not just the Division's *expert* who failed to consider these files. Because the Division itself did not obtain the files for the majority of the loans at issue in this case, its charges against Mr. Aesoph are based on an incomplete investigative record. (J.P.F. ¶¶ 451–54.)

The year-end 2008 audit was the opposite of "perfunctory." The auditors reviewed and tested more than just a handful of impaired loans during the year-end 2008 audit, and they generated more than just a few pages of audit documentation. Pursuant to the professional literature, Mr. Aesoph and his team evaluated TierOne's comprehensive process for estimating the ALLL, which, as Mr. Aesoph described in testimony and as a diagram admitted into evidence depicted (*see* Exhibit A to this brief), covered the Bank's *entire* \$3 billion loan portfolio. That included the portion accounted for under Statement of Financial Accounting Standards No. 5 ("FAS 5"), as well as the portion the Division takes issue with, which is accounted for under Statement of Financial Accounting Standards No. 114 ("FAS 114").

The audit was planned with this comprehensive estimation process in mind and with full recognition of the risks in TierOne's loan portfolio. Because of that heightened risk, Mr. Aesoph expanded the audit procedures over the ALLL, resulting in a 50% increase in hours spent on the 2008 audit as compared to 2007. (J.P.F. ¶ 180.) Part of that increase in audit work was performed by a KPMG credit specialist, whom Mr. Aesoph specifically engaged to assess critical elements of TierOne's loan loss estimation process. (J.P.F. ¶ 183.) An additional portion of the increased hours resulted from Mr. Aesoph's decision to apply varying levels of procedures to the

Bank's FAS 114 templates at each quarter, with *every* template reviewed at year-end. (J.P.F. ¶¶ 317, 322.) Another portion resulted from increased test work over TierOne's ALLL-related internal controls. (J.P.F. ¶¶ 250–51.) And another portion of the increased audit work consisted of close attention that the auditors paid to the regulatory actions by the Office of Thrift Supervision ("OTS"), TierOne's primary federal regulator. (J.P.F. ¶¶ 191, 194, 198–204.)

The auditors also devoted substantial attention to Nevada, TierOne's riskiest lending market. What they found there did not support the Division's contention of management "bias." Nor did it suggest that TierOne was "ignoring" the declining markets and booking losses "wholly inconsistent" with indices of housing prices, as Mr. Barron postulated. To the contrary, the auditors observed TierOne book losses of nearly 30% on impaired Nevada loans—a number that was entirely consistent with the 33% market price decline suggested by the indices. Indeed, compared to the indices, the 30% losses were *conservative*: the decline in the Nevada real estate market in 2008 was fueled largely by distressed sales, which are *not* indicative of fair value under the governing accounting standards. *See infra* section II.A.4.

In short, there can be no doubt that the auditors fulfilled their professional duties. The Division's own audit expert, Mr. Barron, agreed with every risk assessment made during the course of the audit, and he conceded that critical procedures performed during the audit demonstrated the auditors' due care. (J.P.F. ¶¶ 473–74, 489–91.) Mr. Barron further conceded that Mr. Aesoph understood all relevant professional guidance and had an accurate understanding of TierOne's multi-faceted ALLL estimation process. (J.P.F. ¶ 471.) The auditors tested every portion of that process and obtained assurance that the Bank's impaired loan loss estimates were reasonable. Nothing about the audit was "perfunctory."

Rule 102(e) was designed to address egregious departures from professional standards, not the conduct established by the proof at the hearing. The heightened negligence provisions of Rule 102(e) that form the basis of the Division's charges apply only to misconduct that poses "a future threat to the Commission's processes." Amendment to Rule 102(e), 63 Fed. Reg. 57164, 57166 (Oct. 26, 1998). This is a serious case carrying serious professional consequences for Mr. Aesoph.

Yet the Division's approach has been to misinterpret GAAP; ignore work that was undisputedly planned, performed, and documented; and pluck a few work papers out of context, all in an effort distract the Court from the fact that the Division's allegations of professional misconduct are nothing more than second-guesses of good-faith professional judgments made during a challenging economic time. This hindsight bias is made more troubling by the Division's insistence in ignoring what has come to light since the audit: high-ranking members of TierOne's management engaged in a collusive fraud involving the very loans at issue in this proceeding. The Commission has filed charges against those members of management, making clear in its complaints that the fraud was directed against Mr. Aesoph and his engagement team. The Division's insinuations at trial about the causes of TierOne's eventual failure neglected to mention anything about this fraud—even though the Bank's primary federal regulator believed in early 2009, as the audit team did, that these very members of management were capable of steering the bank through the financial crisis. See *infra* section IV.C.

Even if the Division had demonstrated an error in judgment in this challenging audit environment, which it did not, a violation of GAAP or GAAS is not alone sufficient to prove a violation of Rule 102(e). *See McNeeley*, Exchange Act Rel. No. 68431, 2012 WL 6457291, at *8 (Dec. 13, 2012). Moreover, the Division has presented *no* evidence that the "degree of the departure from professional standards" was so "glaring" or "egregious" that it satisfies the heightened negligence provisions of Rule 102(e). *Id.* at *8, *15–16. In deciding whether the conduct here violated Rule 102(e), this Court should consider not just what the evidence shows but also what is conspicuously absent. Mr. Barron—the expert the Division chose to present its theory of this case—never once testified that any of the conduct at issue was so glaring or egregious as to constitute "repeated instances of unreasonable conduct" or "a single instance of highly unreasonable conduct."

As demonstrated in this Brief, Mr. Aesoph and his team fully satisfied every professional standard at issue in this matter, *see infra* section II, and the testimony of the Division's two experts did not provide any evidence to the contrary. *See infra* section III. But more fundamentally, Mr. Aesoph's demonstrated competence and professionalism, his hands-on approach to audit supervision, and his recognition of audit risks and corresponding expansion of audit procedures, keenly illustrate why the charges in this case fall far short of a Rule 102(e) violation. *See infra* section IV. There is no basis for the charges against Mr. Aesoph. Based on the evidence, they must be dismissed.

II.
MR. AESOPH AND HIS TEAM SATISFIED PROFESSIONAL STANDARDS

To prevail in this case, the Division bears the burden of proving that Mr. Aesoph's conduct during the year-end 2008 audit "result[ed] in a violation of applicable professional standards." Rule 102(e)(1)(iv); *see* Amendment to Rule 102(e), 63 Fed. Reg. at 57166. It must then prove that the alleged violation was egregious enough to satisfy the heightened negligence standard of Rule 102(e), such that Mr. Aesoph poses a "future threat to the Commission's processes." 63 Fed. Reg. at 57166 & n.26. The Division cannot satisfy either of those requirements. This section of Mr. Aesoph's Post-Hearing Brief, like the record of the hearing, demonstrates that Mr. Aesoph and his team fulfilled their professional obligations. In Section IV, the Brief explains that, even assuming for the sake of argument a violation of professional standards, the Division failed to make the requisite showing to satisfy the heightened negligence standard of Rule 102(e).

In carrying its burden under Rule 102(e), the Division must take the professional standards as they are written; it cannot interpret them to mean what they do not say or invent new ones. Nor can the Division rely on a few hand-selected work papers to the exclusion of the entire audit record. In planning and performing the audit, Mr. Aesoph was not trying to anticipate allegations the Division might make in a proceeding held more than four years after the close of the 2008 fiscal year. Instead, his focus was on the planning, supervision and execution of the 2008 TierOne audit. His conduct must be judged accordingly. *See* 63 Fed. Reg. at 57168 (Rule 102(e) "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 . . . ."). When viewed as a whole and measured by the standards that governed Mr. Aesoph's conduct and professional judgments in 2008, the audit procedures documented in the work papers fully satisfied every "applicable professional standard."

A. Mr. Aesoph appropriately concluded, based on comprehensive audit procedures and sufficient competent audit evidence, that TierOne's ALLL estimate—inclusive of the FAS 114 portion—was reasonable at year-end 2008.

In planning and performing the substantive audit procedures, Mr. Aesoph and his audit team were "responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole." (J.P.F. ¶ 78 (Resp'ts Ex. 61, AU § 342.04).) This was an important responsibility that Mr. Aesoph and his team took seriously as professionals. But it was distinct from the responsibility of TierOne's management. The auditors, for example, were not responsible for making the estimate itself; that was the Bank's job. (J.P.F. ¶ 39.) Nor were the auditors responsible for opining on the individual assumptions that underlay the ALLL—for example, the assumptions TierOne used to estimate the fair value of collateral securing impaired loans. (J.P.F. ¶ 97 (Resp'ts Ex. 60, AU § 328.32) ("Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient competent audit evidence to provide an opinion on the assumptions themselves.").) And the guidance makes clear that the auditors would have violated their duties had they substituted their judgments and assumptions for those reasonably employed by management: "a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." (J.P.F. ¶ 84 (Resp'ts Ex. 57, AU § 312.36).)

The impaired loans that are the subject of the Division's criticisms were "collateral dependent" under FAS 114, which meant that the Bank expected to recoup its investment in the loans through the sale of real estate collateral. (J.P.F. ¶ 52.) As TierOne disclosed to the public in its 2008 Form 10-K, estimating losses on its impaired loans was not a matter of applying a set formula.

Generally Accepted Accounting Principles ("GAAP") required the Bank to base its impaired loan loss estimates on the "fair value" of the underlying real estate. Under FAS 157, fair value is not synonymous with market price. It is instead the result of a hypothetical sale free from the pressures that typify liquidations or distressed transactions. As the Commission's

Office of Chief Accountant explained in guidance it and the Staff of the Financial Accounting Standards Board issued in September of 2008, "[t]he results of disorderly transactions are not determinative when measuring fair value." (J.P.F. ¶ 59 (Resp'ts Ex. 66, SEC Release No. 2008-234).) Yet the majority of sales in Nevada at the time were subject to precisely those pressures. Economist and banking expert Chris James explained the phenomenon: based on conservative estimates, a staggering 58% of single-family home sales in Las Vegas by the end of 2008 were disorderly fire sales. (J.P.F. ¶ 500.)

In determining the price that might be obtained in a hypothetical orderly transaction in a market flush with distressed sales, TierOne was required to rely on "unobservable inputs"—*i.e.*, TierOne's "own assumptions about the assumptions market participants would use in pricing the asset." (J.P.F. ¶¶ 63–64 (Resp'ts Ex. 45, FAS 157 ¶ 21.b).) Real estate appraisals were among the data that TierOne considered, as were market price indices such as Case-Shiller. But those were only starting points. Precision was impossible, and judgment permeated the entire process.

The Division is therefore incorrect when it argues, as it did at the hearing, that evaluating the reasonableness of TierOne's ALLL estimate was simply a matter of using market pricing trends to extrapolate losses on individual loans. (Tr. 2288:18–23 (Division's Counsel).) The estimation process was multifaceted and dependent on management judgment, with each part of the process informing the others. For this reason, Mr. Aesoph and his team carefully focused their procedures on the estimation process; identified potential risks during the planning phase of the audit; enhanced their audit procedures over the ALLL, including the FAS 114 portion; tested the critical parts of the process; and considered all, not just some, of the evidential matter they obtained. The Division's criticisms of the substantive audit procedures simultaneously misapply professional guidance and ignore the work that the auditors actually did.

1. The auditors appropriately assessed the risks associated with the ALLL, evaluated regulatory actions by the OTS, expanded their procedures, and focused on Nevada, TierOne's riskiest lending market.

The Division does not dispute that Mr. Aesoph and his audit team identified the risks relevant to TierOne's ALLL and addressed each of them in planning the audit. When asked if he agreed with these risk assessments, Division expert John Barron repeatedly answered, "Yes." (Tr. 1164:15–67:16 (Barron).).

The risks the auditors identified included a range of considerations. For example, "the economic downturn in the banking industry driven by delinquencies in the housing and real estate markets," created the potential for "increased pressure to improve financial performance" and the incentive to understate the ALLL. (J.P.F. ¶ 163 (Resp'ts Ex. 3, Work Paper C-2, KPMGTO 3699).) The risks also included the fact that the ALLL was an estimate, subject to judgment and requiring management to possess specific competencies relevant to the estimation process. (J.P.F. ¶ 177.) In addition, the auditors determined that the ALLL was subject to a risk of fraud, and they evaluated that risk with the help of forensic experts—something Mr. Barron agreed was a "good move." (J.P.F. ¶ 174 (Tr. 1213:1–11 (Barron)).) The auditors identified the bank's capitalization levels, *i.e.*, its capital ratios, as an industry-specific fraud consideration that could cause management to avoid booking needed loan loss reserves and included the topic in an engagement team discussion with the forensic specialists. (J.P.F. ¶ 173.) In light of these risks, the audit team "elected to revise [its] assessment [of ALLL's risk] to high," meaning that the team would exercise "a heightened sense of awareness regarding loan valuation and credit risk" and "modif[y its] audit approach with respect to loan valuation." (J.P.F. ¶ 176 (Resp'ts Ex. 3, Work Paper C-1, KPMGTO 3689).) Again, the Division does not challenge these assessments; its expert explicitly agrees with them. (Tr. 1165:19–21 (Barron).)

The Division also does not refute that Mr. Aesoph and his team devoted close attention to the regulatory actions that the Office of Thrift Supervision took in 2008. For example, shortly after Mr. Aesoph received the OTS's 2008 Report of Examination ("Report" or "ROE"), he asked Mr. Bennett to draft a memorandum analyzing the significant criticisms contained in the Report and explaining how TierOne was addressing them. (J.P.F. ¶¶ 194–97.) Mr. Aesoph consulted experienced audit partners at KPMG to obtain their views on the OTS Report (J.P.F. ¶ 199), and he engaged the services of KPMG regulatory specialists to interpret the practical consequences of the OTS's actions (J.P.F. ¶ 198). The auditors also tracked the Bank's compliance with the OTS Supervisory Agreement, obtaining evidence that the Bank was fulfilling the promises it had made to its regulator. (J.P.F. ¶ 201.) As Mr. Aesoph explained, the auditors observed that the Bank made a number of "significant enhancements to its processes" in 2008. (Tr. 1739:16–21 (Aesoph).) The Bank, for example, instituted a Problem Loan Committee to meet on a weekly basis to review troubled loans. (J.P.F. ¶ 216.) The Bank also hired a slate of new personnel: a Chief Credit Officer, a Special Asset Executive, and an Internal Asset Review Executive who was independent of management and reported directly to the Audit Committee of the Board of Directors. (J.P.F. ¶¶ 212, 216.) The auditors reviewed the experience and credentials of these new personnel, which provided assurance that the Bank was "making the right personnel changes." (Tr. 1740:1–16 (Aesoph).) These various moves by TierOne, taken together, were significant to Mr. Aesoph. They demonstrated that "management was actively dealing with not only the OTS's comments but the heightened risk around the impaired loan portfolio." (J.P.F. ¶ 216 (Tr. 1741:4–8 (Aesoph)).) That is, "management was doing the right thing; they were moving in the right direction." (J.P.F. ¶ 216 (Tr. 1742:20–43:3 (Aesoph)).)[3]

After doing all of this work, both Mr. Aesoph and Mr. Bennett spoke directly to a senior official at the OTS, Field Manager Douglas Pittman, to confirm that the evidence the auditors had obtained was consistent with the views that the OTS itself held. (J.P.F. ¶ 204.) This conversation provided assurance that TierOne "appear[ed] to have the ability to appropriately address the OTS comments" and was "working diligently to clear the issues noted by the OTS." (J.P.F. ¶¶ 204, 209 (Resp'ts Ex. 1, Work Paper A-7.1, KPMGTO 2573–74).) In Mr. Aesoph's words, Mr. Pittman confirmed that TierOne's enhanced processes demonstrated the Bank's "ability to deal with the issues at hand." (J.P.F. ¶ 204 (Tr. 1742:14–43:3 (Aesoph)).)

At trial, Mr. Pittman's testimony confirmed the auditors' account of this conversation to the word. (J.P.F. ¶ 210.) Mr. Pittman also confirmed that when this conversation took place in February of 2009, he had received and reviewed a battery of submissions TierOne provided the OTS at the end of 2008. (J.P.F. ¶ 207.) In other words, when Mr. Pittman told the audit team that TierOne was "appropriately addressing concerns raised in the ROE," this was based not on conjecture but on the very information the OTS had obtained from the Bank. (J.P.F. ¶ 207 (Tr. 1458:12–59:14 (Pittman)).) This and other evidence completely undermined the Division's attempt at the hearing to characterize the OTS Report as a "red flag." The procedures the audit team devoted to this area, Mr. Barron had to admit, demonstrated due care. (J.P.F. ¶ 491.)

[3] The auditors also noted that the Bank booked losses at June 30, 2008 that *exceeded* the range recommended by the OTS. As noted in the work papers, the OTS identified a "deficiency" in the ALLL "ranging between $17.0M and $22.0M at March 31, 2008." (J.P.F. ¶ 195 (Resp'ts Ex. 1J, Work Paper A-7, KPMGTO 2570).) TierOne "addressed [the OTS] concerns by recording $28.4M of loss provisions during the quarter ended June 30, 2008." (J.P.F. ¶ 197 (Resp'ts Ex. 1J, Work Paper A-7, KPMGTO 2570).)

These risk assessments and regulatory considerations—none of which the Division has challenged and many of which the Division's audit expert endorsed—were not just academic matters. They were a critical part of the audit because they drove the audit procedures themselves. It was the heightened risk related to the ALLL that prompted the auditors to expand their work over that financial statement assertion. These considerations also led the auditors to focus their attention on the Bank's most troubled markets and, in particular, Nevada. By dollar value, Nevada accounted for 42% of TierOne's delinquent loans[4] and nearly half of the Bank's impaired loans. Other markets represented a far smaller portion. Nebraska was the next-largest market in terms of delinquent loans, at 15.5%. Arizona accounted for just 5.4%. As Ms. Johnigan explained, the auditors "were looking at it by state and by those states that were the most stable, to those states that were not stable at all." (J.P.F. ¶ 364 (Tr. 1935:4–20 (Johnigan)).) This risk-based focus is precisely what auditors are supposed to do. (*Id.*)

2. Mr. Aesoph and his team reviewed and tested TierOne's estimation process under AU § 342.10 and evaluated the total loss recognition—including charge-offs—reflected in TierOne's financial statements.

PCAOB standards provide independent auditors a choice of three options, any one of which they may use to test an accounting estimate reported on a company's financial statements. (J.P.F. ¶ 80.) Mr. Aesoph chose the first option: "Review and test the process used by

[4] Mr. Aesoph explained at the hearing that, as a general matter, "TierOne's policy was to identify an impaired loan when it bec[ame] 90 days delinquent." (J.P.F. ¶ 243 (Tr. 972:19–24 Aesoph)).) TierOne also evaluated loans not yet 90 days past due so that impaired loans would not escape early detection: "[R]ather than waiting for a loan to get 90 days past due and recognize it as impaired, there were loans in the portfolio that were current or not yet 90 days that the company, based on their analysis of the borrower, their review of the credit, would determine . . . was non-performing and an impaired loan." (J.P.F. ¶ 243 (Tr. 973:6–14 (Aesoph)).) In Nevada, this policy resulted in the Bank deeming *every* delinquent loan to be impaired—even loans that were not yet 90 days past due. (J.P.F. ¶ 367.)

management to develop the estimate." (J.P.F. ¶ 83.) As a result, he and his team were not required to develop an "independent expectation" of the ALLL, which was one of the other two options under the guidance. (J.P.F. ¶ 80 (Resp'ts Ex. 61, AU § 342.10).) Rather than generate a specific number against which to compare TierOne's reported ALLL, the auditors planned their procedures to obtain evidence that TierOne's estimation process was consistent with applicable accounting principles, considered relevant information and assumptions, and produced a reasonable result. Ms. Johnigan, an expert in banking audits and a member of the Auditing Standards Board of the American Institute of Certified Public Accountants, agreed that this was the best approach: "[T]he auditors determined that they would review and test the process used by management. And that, in my experience, on larger institutions, that is the most reasonable way to approach it." (J.P.F. ¶ 81 (Tr. 2002:5–15 (Johnigan)).) Mr. Barron also agreed, opining that testing TierOne's ALLL estimation process made "the most sense." (J.P.F. ¶ 83 (Tr. 1119:12–15 (Barron).) In other words, the Division has no basis to challenge, and has not attempted to challenge, the overall approach Mr. Aesoph determined to employ to assess the reasonableness of TierOne's ALLL.

The "process" that the auditors evaluated encompassed more than estimating collateral values for a handful of impaired loans. It included every part of the ALLL, including the FAS 5 and FAS 114 portions, which in aggregate resulted in the financial assertion on the balance sheet. (J.P.F. ¶ 82.) As Exhibit A to this Brief illustrates, a major part of the estimation process was the assignment of risk ratings to some $2.1 billion of non-homogeneous, non-impaired loans under Statement of Financial Accounting Standards No. 5 ("FAS 5").[5] This was a critical juncture in

---

[5] A "homogeneous" loan is a small-balance loan such as a home equity or education loan. (J.P.F. ¶ 220.) Those loans were pooled for purposes of loan loss estimation. (J.P.F. ¶ 221.)

(Cont'd on next page)

the estimation process; the point at which the Bank "risk rated" its loans and determined, based on judgment, whether individual loans were impaired under FAS 114. This loan-by-loan judgment led to the identification of $226 million of gross impaired loans at year-end 2008. TierOne then estimated losses on those loans by drawing on a wealth of information contained in the Bank's loan files, each of which could comprise several banker's boxes full of internal credit reviews, borrower-supplied financial records, and third-party evidence such as appraisals, tax records, and other market data.

The Division and its audit expert never criticized any of the work relating to the largest portion of the ALLL, the FAS 5 portion covering some $2.9 billion of TierOne's non-impaired loans. Mr. Barron testified that he developed no opinion on "the work done by Mr. Bennett and Mr. Aesoph with respect to the FAS 5 component" of the ALLL. (J.P.F. ¶ 222 (Tr. 1162:2–6 (Barron).) This piecemeal approach leads to an inaccurate picture of Bank's estimation process and the auditors' evaluation of it. For example, the Division's allegations ignore a key juncture in the estimation process: the judgmental decision to determine risk ratings for individual non-homogeneous loans, including whether those individual loans were impaired and should be subjected to the estimation process of FAS 114. Mr. Aesoph testified, and the Division did not dispute, that "this is a critical point in the decision process in the company's monitoring of loans.'" (J.P.F. ¶ 184 (Tr. 971:3–11 (Aesoph).) This is why Mr. Aesoph devoted significant resources to test that decision—including the engagement of a KPMG credit risk specialist whose work the Division has not challenged in any respect. (J.P.F. ¶ 184.)

(Cont'd from previous page)

At year-end 2008, the loan balance of homogeneous loans was approximately $834 million. (J.P.F. ¶ 220.) "Non-homogeneous" loans, in contrast, were generally large commercial loans that were individually evaluated and assigned either a FAS 5 risk rating or were deemed impaired and evaluated for losses under FAS 114. (J.P.F. ¶ 220.)

The Division does more than ignore entire portions of the audit work. It also attempts to obscure the substance of the ALLL and the reality that the estimate, in the context of the financial statements taken as a whole, is intended to convey—loan loss recognition. The Division used Mr. Barron to obscure this important point. In response to a question about the auditors' evaluation of "the amount of losses throughout the year," he stated that "[t]he ALLL has a balance sheet date. The fact that [the Bank] may have recorded a lot of losses or charge-offs prior to this date *really is not relevant*." (J.P.F. ¶ 476 (Tr. 1032:16–33:2 (Barron)) (emphasis added).) He maintained this illogical position even while admitting that TierOne's loan loss recognition was a function of *both* the ALLL amount as of the balance sheet date *and* charge-offs that had been taken during the year. (J.P.F. ¶ 476 (Tr. 1031:24–32:8 (Barron)) (admitting that charge-offs "reduce the amount of ALLL that's required at the balance sheet date").)

Neither TierOne, its regulators, nor the auditors viewed charge-offs as irrelevant; doing so would have been contrary to basic accounting principles. Charge-offs were reflected on the FAS 114 templates for all loans with collateral deficiencies, at each quarter and at year-end 2008. Without understanding those numbers and the reasons for them, the auditors could not understand the Bank's loan loss estimates for individual impaired loans. As Ms. Johnigan explained, "unless you understand the charge-offs, you don't understand what's happening with the loans. You don't understand what the composition of the [loan loss] provision is and whether or not it affects the current year. I mean, it is how you are able to see what is happening with the bank." (J.P.F. ¶ 476 (Tr. 1923:25–24:5 (Johnigan)).) In particular, without considering charge-offs, it would not be possible to understand the total income-statement impact of the Bank's loan loss recognition at year-end, nor would it be possible to understand the effect of those losses on the assets carried on the Bank's balance sheet. (J.P.F. ¶ 121.) The Division's refusal to recognize the charge-off line item on TierOne's FAS 114 templates does not remove it from the estimation process.

The Division has no choice but to try keeping charge-offs out of the discussion, though, because otherwise the Division is unable to pursue its theory that TierOne's recognized losses on impaired loans were a "red flag." As Mr. Barron himself was forced to concede, in 2008 TierOne booked losses totaling approximately 22% of the book value of its entire impaired loan portfolio; on these impaired loans in Nevada with collateral deficiencies, the Bank booked losses of approximately 30%. (Tr. 1243:2–15 (Barron).) The vast majority of these losses were recorded as charge-offs; Mr. Barron admitted that "the company charged off about $40 million of its impaired loans" and booked "about a $16 million allowance on its impaired loans," for a total of "about $56 million in losses." (J.P.F. ¶ 314 (Tr. 1243:16–44:8 (Barron)).) By using Mr. Barron to assert that TierOne's charge-off activity "really is not relevant," the Division intends to imply that *over two thirds* of the losses TierOne booked on its impaired loan portfolio were of no consequence to the reasonableness of TierOne's resulting ALLL estimate at year-end 2008. In her more than forty years of experience in the accounting industry, Ms. Johnigan had never heard such a contention. (J.P.F. ¶ 476.)

The Court should reject the Division's attempt to hide the significance of charge-offs. The 2008 financial statements, and therefore the audit itself, cannot be properly understood unless charge-offs—and their related income-statement impact—are considered.

3. The audit procedures, considered as a whole, provided reasonable assurance, based on the estimation process TierOne employed, that its FAS 114 loan loss estimate was reasonable.

The way the Division characterizes things, the sum total of the auditors' FAS 114 procedures is contained within a single two-page summary memorandum, work paper reference L-32, entitled "FAS 114 Procedures." (*See* Tr. 2290:7–13 (Division's Counsel).) In the Division's view, any procedures related to FAS 114 that were documented elsewhere simply don't count. The Division needs this myopic view for the same reason it needs to declare charge-offs irrelevant to the year-end financial statements: the complete picture proves that the Division's allegations are unfounded.

The auditors in fact employed a multitude of procedures over the FAS 114 portion of the ALLL, and in doing so they went above and beyond what was required by professional guidance. The relevant audit standard, AU § 342.11, lists nine types procedures auditors *may consider* utilizing in testing an estimation process. They are suggestions; an auditor need not perform any particular one of them. (J.P.F. ¶ 88.) Mr. Aesoph, however, planned and executed procedures under *all nine* categories of AU § 342.11. (J.P.F. ¶ 308.) While the Division seeks to persuade the Court to ignore the bulk of the procedures Mr. Aesoph and his team devoted to TierOne's FAS 114 estimate, doing so would be improper and unfair. As explained below, Mr. Aesoph, in forming the audit opinion, considered *all* of the audit procedures and *all* of the resulting evidentiary matter. In evaluating Mr. Aesoph's professional conduct, the Court should do the same.

Mr. Aesoph and His Team Understood and Tested Relevant Controls. The auditors evaluated controls relevant to the ALLL process and the FAS 114 portion of the ALLL in particular. As explained below in Section III.B, those controls addressed the risk that loan collateral for impaired loans might be overvalued, resulting in too little loss recognition in the

Bank's financial statements. (J.P.F. ¶ 250.) Key members of TierOne management—including the Bank's Controller, Mr. Kellogg, who reviewed and approved every FAS 114 template—evaluated detailed reports containing information specific to each impaired loan before signing off on the ALLL and certifying that no additional "Specific or General Reserves" were necessary. (J.P.F. ¶ 288.) The auditors tested these controls and concluded they were designed and operating effectively.

Mr. Aesoph and His Team Understood the ALLL Process, Relevant Data, and Assumptions. The auditors developed a thorough understanding of TierOne's estimation process and the data relevant to it. The Bank's 38-page "Adequacy Analysis," work paper reference L-30A, was a significant resource for the auditors. As Mr. Bennett explained at the hearing, the auditors' understanding of the ALLL process "really started with the company's L-30A memo." (J.P.F. ¶ 219 (Tr. 705:5–17 (Bennett)).) That memorandum explained how the bank segregated its portfolio into homogeneous and non-homogeneous loans; how it evaluated the risks in the $2.1 billion non-homogeneous loan portfolio by loan type (*e.g.*, land development versus residential construction) and market (*e.g.*, Nevada versus Nebraska); how it arrived at loss factors under FAS 5; and how it individually evaluated non-homogeneous loans that met the definition of "impaired" under FAS 114.

In addition to addressing the Bank's overall ALLL process, the L-30A memorandum discussed data and factors relevant to the Bank's individual loan loss estimates. The Bank identified a number of price indices—including Case-Shiller and the National Association of REALTORS—as "just a few of the data sources used to assess ALLL adequacy." (J.P.F. ¶ 311 (Resp'ts Ex. 8, L-30A Memo, KPMGTO 5436–37).) The Bank also cited economic factors that affected estimates of fair value under FAS 157: "[i]nventory of unsold real estate, trends in current sales prices, sales volume of foreclosed properties, and unemployment trends." (*Id.*) As Professor James testified, these were the indicators that showed the predominance of distressed sales in markets like Nevada and Arizona, which made fair value difficult to estimate in 2008. (J.P.F. ¶ 499.) On that point, L-30A explained why TierOne had declined to adopt a blanket policy of ordering new appraisals in Nevada in the latter half of the year: "The Bank believes current 'non-liquidation appraisals' are more indicative of liquidation appraisals because they are based on a limited number of sales many of which are sales of foreclosed property." (J.P.F. ¶ 507 (Resp'ts Ex. 8, L-30A Memo, KPMGTO 5450).) Professor James' testimony confirms that the auditors had every reason to view management's belief as reasonable. (J.P.F. ¶ 507.)

Mr. Aesoph and His Team Evaluated the Bank's FAS 157 Disclosure. The FAS 157 disclosure in TierOne's 2008 Form 10-K was critically important to understanding the Bank's estimate of impaired loan losses. The Bank disclosed that, in estimating these losses, it relied not only on "external appraisals" but also "assessment of property values by our internal staff." (J.P.F. ¶ 118 (Resp'ts Ex. 1E, TierOne 2008 10-K, KPMGTO 2214–19).) It further explained that "[b]ecause many of these inputs are not observable, the measurements are classified as Level 3." (*Id.*) This meant that TierOne's FAS 114 loss estimates were, of necessity, based on the least precise evidence recognized by the accounting standards: "inputs that reflect an entity's own assumption about the assumptions that market participants would use." (*Id.*)

As Mr. Aesoph testified, the auditors "were involved in the company's preparation of the FAS 157 disclosures that were in its financial statements." (J.P.F. ¶ 119 (Tr. 1743:13–15 (Aesoph)).) He and his audit team evaluated these disclosures for compliance with GAAP, and Mr. Aesoph discussed the application of FAS 157 with the Bank's audit committee, as reflected in a KPMG Power Point presentation retained in the work papers. (J.P.F. ¶ 119.) The management representation letter that Mr. Aesoph requested from the Bank further confirmed that TierOne management understood the implications of its use of Level 3 inputs under FAS 157. (*Id.*) The concept of fair value under FAS 157 was, in Mr. Aesoph's words, "baked into [the auditors'] thinking." (J.P.F. ¶ 376 (Tr. 1779:6–7 (Aesoph)).)

Mr. Aesoph and His Team Performed Targeted FAS 114 Procedures. Based on their understanding of the controls, the estimation process, and the types of inputs the Bank relied upon in estimating impaired loan losses, the audit team performed targeted FAS 114 procedures to address each stage of the Bank's FAS 114 estimate and to conclude on its reasonableness.

- *The Audit Team Tested the Triggering Event.* Before individually estimating loan losses under FAS 114, the Bank had to determine which loans in its $2.1 billion non-homogenous loan portfolio were impaired. Mr. Aesoph engaged a credit specialist[6] to test the Bank's identification of impaired loans through the loan review and risk rating process and instructed his audit team to sub-test loan reviews performed by Internal Audit. (J.P.F. ¶¶ 253–56.) The auditors also reviewed the work of a third-party, the Reynolds Williams Group ("RWG"),[7] which corroborated the auditors' conclusion that TierOne's impairment identification process was reasonable and comprehensive. (J.P.F. ¶¶ 262–66.) Finally, the

[6] At trial the Division implied that the credit specialist reviewed too many loans that were not deemed impaired at year-end 2008 and suggested that she should have reviewed more impaired loans. (Tr. 2292:22–24 (Division's Counsel).) But to assess the Bank's impairment decisions, the specialist also needed to review the other half of the picture: loans that were *not* deemed impaired. Reviewing loans the Bank had already deemed impaired would fail to tell the specialist whether the Bank's process for *identifying* impaired loans was functioning properly.

[7] TierOne engaged RWG as part of the OTS-directed effort to review every loan in the Bank's portfolio with a balance of over $1 million. Mr. Aesoph and his team evaluated the competence and objectivity of RWG and reviewed RWG's work to obtain assurance that the audit team's own procedures were "adequate to conclude on the assertions related to the ALLL." (J.P.F. ¶ 262 (Resp'ts Ex. 3, Work Paper C-6.2, KPMGTO 3739).) By the time of the audit, RWG had evaluated 144 lending relationships comprising 480 loans with a total outstanding balance of $785 million. (J.P.F. ¶ 263.) Of this number, RWG identified only one lending relationship as potentially non-accruing. (J.P.F. ¶ 264.) In response, the Bank evaluated this lending relationship for impairment and concluded that if it were deemed impaired, it would carry no reserves. (J.P.F. ¶ 264.) The Bank ultimately determined that the loan was not impaired and booked losses on the loan under FAS 5. (J.P.F. ¶ 264.)

auditors reviewed the work of the OTS itself. As part of its 2008 examination, the OTS reviewed nearly 90% of loans in TierOne's riskiest lending market, Nevada, and evaluated the impairment status of those loans. (J.P.F. ¶ 267.) Mr. Aesoph and his team considered the OTS's findings, noting that they were "consistent with our loan review procedures." (J.P.F. ¶ 267 (Resp'ts Ex. 8, Work Paper L-30, KPMGTO 5428).)

- *The Audit Team Obtained Assurance that the FAS 114 Methodology was Reasonable*: The audit team's Credit Specialist evaluated TierOne's FAS 114 methodology and concluded that it was reasonable. (J.P.F. ¶ 352.) She was intimately familiar with the Bank's loan files and understood the inputs available to assess the loans and how Bank personnel evaluated each loan based on this information. As the work papers document, Ms. Washek's concurrence with the methodology, based on her extensive banking experience and loan review procedures, provided the audit team additional assurance that the FAS 114 component of TierOne's loan loss estimate was reasonable. (J.P.F. ¶ 352.) The OTS agreed that TierOne's FAS 114 methodology was reasonable, describing TierOne's FAS 114 template as an "appropriate" method "to measure quarterly impairment loss on impaired loans pursuant to SFAS No. 114." (J.P.F. ¶ 212 (Div. Ex. 81, 2008 OTS Report of Examination, KPMGTO 1393).) One OTS official further concluded that the templates "greatly enhanced" "the adequacy of [TierOne's] ALLL." (J.P.F. ¶ 213 (Resp'ts Ex. 151, OTS Internal Memo).)

- *The Audit Team Understood and Tested Assumptions Applied to Each Loan*: The auditors evaluated assumptions used in each of the Bank's FAS 114 calculations, including estimated selling costs (which generally varied from 5% to 10%, a reasonable range in light of evidence the auditors obtained from their test work over TierOne's sales of bank-owned properties) and the number of months to sell (which, the auditors noted, "depends on the circumstances around each individual loan," including whether "loans are currently in a workout situation" and "the region and market [where] the property is located"). (J.P.F. ¶ 321 (Resp'ts Ex. 8, Work Paper L-32, KPMGTO 5482–83).)

- *The Audit Team Obtained Evidence that TierOne Individually Evaluated Impaired Loans Using Reliable, Reasonably Available, and Appropriate Information*: The FAS 114 templates, each of which the auditors reviewed and many of which the auditors subjected to detailed testing, demonstrated that TierOne appropriately evaluated impaired loans on an individual basis, as FAS 114 requires. (J.P.F. ¶ 322.) To assess individual FAS 114 loan loss estimates, the auditors reviewed the Bank's loan files, where corroborating information to support collateral value estimates was found. (*Id.*) According to the Division's own expert, there is "no reason to doubt" that the auditors reviewed loan files and used them to understand and corroborate the numbers reflected in the FAS 114 calculations. (J.P.F. ¶¶ 335–36 (Tr. 1327:19–38:2 (Barron)).)

- *The Audit Team Identified and Evaluated Areas in which Loan Losses Might Avoid Detection*: Multiple parties throughout the year had reviewed TierOne's non-homogenous loans (including the KPMG credit specialist, the Bank's Internal Audit Department, RWG, and the OTS). This was persuasive evidence that additional, unidentified losses were not lurking in the Bank's $2.1 billion portfolio of non-homogenous FAS 5 loans as of December 31, 2008. In addition, the auditors obtained evidence that TierOne was taking proactive steps to recognize impaired loan losses, such as evaluating for impairment loans that were not yet

> 90 days past due and booking FAS 5 reserves on loans that would have carried no losses under FAS 114. (J.P.F. ¶¶ 403–04.)

Mr. Aesoph and His Team Analyzed Trends and Overall Loss Recognition. After obtaining evidence that TierOne's process for identifying impaired loans was effective and TierOne had individually evaluated impaired loans using appropriate data and assumptions, the auditors analyzed the overall loss numbers to obtain assurance that the outcome of the FAS 114 estimation process was reasonable. As Mr. Bennett explained, "we had to evaluate the loans on a loan-by-loan basis. But at the end of the day, we had to take a step back and evaluate the allowance for loan loss in the context of the financial statement[s] taken as a whole." (J.P.F. ¶ 412 (Tr. 556:23–57:2 (Bennett)).) This is precisely what the auditing guidance contemplates when it states,

> The objective of the audit procedures is therefore not intended to obtain sufficient competent audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole.

(J.P.F. ¶ 97 (Resp'ts Ex.60, AU § 328.32).) As Ms. Johnigan explained, "this is about reviewing and testing the process. And this is about deciding whether that process has created a reasonable result." (J.P.F. ¶ 415 (Tr. 1997:19–22 (Johnigan)).)

The work papers exhaustively document the auditors' understanding of TierOne's overall impaired loan loss estimate, including the auditors' understanding of impaired loan losses by individual geographic market. (J.P.F. ¶¶ 355–58.) By way of a simple calculation using numbers reported in one of these work papers—a calculation that, as Mr. Barron admitted, any auditor could perform as a matter of routine and in a matter of minutes (J.P.F. ¶ 378 (Tr. 1364:23–65:2 (Barron)))—the auditors knew that in Nevada, the Bank's most distressed market, TierOne had recognized approximately 30% in impaired loan losses. (J.P.F. ¶¶ 375, 377.)[8] Based on what the auditors knew from the market data referenced in the Bank's L-30A memorandum, this number appeared reasonable. (J.P.F. ¶ 376 (Tr. 537:13–24 (Bennett)).) With this information in mind, the auditors discussed impaired loan losses with Bank management, asking "whether there are other properties in which [management] believe[s] additional reserves are necessary under FAS 114." (J.P.F. ¶ 373 (Resp'ts Ex. 8, Work Paper L-30, KPMGTO 5428).)[9]

The Court heard a substantial amount of testimony on these overall numbers. For example, Ms. Johnigan prepared a compilation of data drawn directly from the work papers, attached as Exhibit B to this brief. The compilation illustrates that TierOne recognized 22% losses on its entire portfolio of impaired loans and 30% losses on impaired loans in Nevada with collateral deficiencies. Mr. Barron attempted to criticize Ms. Johnigan's data, but he admitted that her method of calculating losses using information from the work papers was "perfectly acceptable" and that the 30% loss recognition in Nevada "of course, is, in fact, consistent with the annual decline in single family residential home prices in Nevada." (J.P.F. ¶ 379 (Tr. 1146:7–18 (Barron)).) Another chart, attached as Exhibit C to this brief, displayed the quarterly loss recognition on Nevada impaired loans, showing that those losses closely tracked the decline in the Case-Shiller index. (J.P.F. ¶ 380.) While the Division attempted to argue that these charts

[8] The Division argued at the hearing that if loan loss reserves that existed at the beginning of 2008 are excluded from the numbers, the calculation yields 26%, not 30%. (Tr. 2109:17–20 (Division's Counsel).) As Ms. Johnigan testified, however, the 26% figure is distorted because it includes loans that "had no losses taken on them and had excess collateral." (Tr. 1937:7–8 (Johnigan).) The auditors understood that the relevant figure was 30%. (J.P.F. ¶ 377.)

[9] The Division argued at the hearing that the auditors' documentation of its discussions with management—and, specifically, a conversation with Controller David Kellogg—was deficient. As explained at section II.C, *infra*, that claim has no merit.

were irrelevant because the audit work papers presented the data in a different form,[10] no witness disputed that the auditors documented and understood the overall loss numbers and considered them in reaching their audit conclusions.

Mr. Aesoph and His Team Tested Management's Calculations. Finally, the auditors tested the Bank's ALLL calculations, both at the level of the ALLL as a whole and at the individual impaired loan level, as documented by the test work applied to the Bank's individual FAS 114 templates. (J.P.F. ¶ 389.) This was the "ticking and tying" that the Division criticized at trial. But these recalculations were only one step in a comprehensive audit—they were not, as the Division implied, the sum and substance of the auditors' work.

4. The Division's criticisms reduce to a single erroneous proposition: in the second half of 2008, TierOne was required to calculate losses on a handful of loans using price indices dominated by distressed sales.

The Division's criticism of the comprehensive procedures described above reduces to a singular assertion—that because the 2008 appraisals for 9 Nevada loans and 4 Arizona loans were "stale," TierOne should have relied on declines in raw market price indices to book additional losses on them in the second half of the year. The Division stated in closing argument, using a particular Nevada loan as an example, that "the proposition is that [TierOne had] not adjusted that April 2008 appraisal to account for declines in the market from the appraisal date until year-end. . . . And that basic proposition should have raised serious red flags . . . . [T]here had been significant market decline since the dates of the appraisals." (Tr.

[10] Ms. Johnigan explained that she did not expect the work papers to mirror her expert report, because much of her report was "created very specifically to rebut Mr. Barron." (J.P.F. ¶ 380 (Tr. 2182:18–20 (Johnigan)).) She testified that the auditors, in conducting their audit in 2009, "wouldn't be auditing to a rebuttal of an expert report." (*Id.* (Tr. 2183:13–14 (Johnigan)).) In any event, Ms. Johnigan's analysis used only data that was documented in the work papers.

2288:6–21 (Division's Counsel).) This argument is based on a fundamental misunderstanding of GAAP and the responsibilities of independent auditors.

Because the raw price indices on which the Division's allegations rely were heavily influenced by the type of "disorderly transactions" that must be excluded from consideration under FAS 157, those indices were not determinative of fair value at year-end 2008. *See infra* section III.B. Even Professor Thakor, the Division's economist, admitted that the indices were influenced by a staggering proportion of distressed sales. (J.P.F. ¶¶ 516-517.) Given the economic upheaval of the financial crisis, the auditors considered the indices not as substitutes for individual fair value estimates but as additional data points providing a level of assurance that management's impaired loan losses appeared reasonable. (J.P.F. ¶ 352.) In Nevada, where distressed sales overwhelmingly drove market declines, a 30% loss on TierOne's impaired loans with collateral deficiencies—within a few percentage points of the decline in the Case-Shiller index—was *conservative*. In other words, the declines in market prices *overstated* declines in fair values. (J.P.F. ¶ 376.)

Moreover, as the Division concedes, nowhere in the accounting literature are "stale" appraisals discussed or defined, nor does the literature require creditors to use "current" appraisals to arrive at fair value. (J.P.F. ¶¶ 67–68 (Tr. 25:4–6 (Division's Counsel), Tr. 1240:17–21 (Barron)).) The guidance instead states that in developing Level 3 inputs, a creditor must consider information that is "reasonably available without undue cost and effort." (J.P.F. ¶ 64 (Resp'ts Ex. 45, FAS 157 ¶ 30).) During the 2008 audit, "reasonably available" as well as then-current information, reflected for instance in the L30-A memorandum, included the fact that the Nevada and Arizona real estate markets "were very illiquid in the latter part of 2008" and had "frozen" by the end of the year, as Mr. Aesoph testified. (J.P.F. ¶ 365 (Tr. 784:24–85:1 (Aesoph)).)

The L-30A memorandum described this phenomenon in its discussion of "[i]nventory of unsold real estate, trends in current sales prices, sales volume of foreclosed properties, and unemployment trends." (J.P.F. ¶ 310 (Resp'ts Ex. 8, L-30A Memo, KPMGTO 5437).) Based on these realities, the Bank concluded that appraisals obtained in the first half of 2008 were reasonable indicators of fair value at year-end. But, in the Bank's reasoned judgment, later appraisals were "more indicative of liquidation appraisals because they [were] based on a limited number of sales many of which are sales of foreclosed property." (J.P.F. ¶ 507 (Resp'ts Ex. 8, L-30A Memo, KPMGTO 5450).) As Mr. Aesoph explained, "TierOne was not the only bank to have that concern. There were a number of banks with that exact same concern." (J.P.F. ¶ 370 (Tr. 786:11–13 (Aesoph)).)[11] The auditors concluded that it was "not unreasonable" for TierOne to use 2008 appraisals obtained when markets were more orderly to value loans after markets had become extremely disorderly. (J.P.F. ¶ 376 (Tr. 787:3–11 (Aesoph)).)

At trial, the Division implied that Mr. Aesoph and his team were obligated to replicate the later work by economist and banking expert Christopher James when he developed his opinions for this litigation: assess TierOne's loan loss estimates by comparing them to market price indices adjusted to exclude distressed sales.[12] In its closing argument, the Division stated, "it is undisputed . . . that the auditors did not perform procedures to remove distressed sales from

[11] The timing of the Office of the Chief Accountant's clarifying guidance regarding the effect of disorderly markets on fair value estimates—released in September 2008—was not merely coincidental. (J.P.F. ¶¶ 58-60.)

[12] Professor James performed those procedures not because they are required by auditing standards but specifically to demonstrate that Professor Thakor's reliance on raw market price declines, instead of fair values, to estimate loan losses blatantly violates FAS 157. (J.P.F. ¶¶ 503–04.)

Case-Shiller, that they did not perform procedures to remove distressed sales from the NAR index they consulted." (Tr. 2303:6–12 (Division's Counsel).)[13] The Division offered no support for the proposition that this type of procedure is required, much less that it is even suggested, by auditing or accounting standards. The Division merely offered up their own expert's view that the procedure "would be an excellent idea." (Tr. 2236:6–7 (Barron).) The test, however, is not whether an audit procedure qualifies as an excellent idea in the mind of one expert witness; the auditors instead performed procedures to comply with the professional guidance. And there are two reasons why the guidance did not require Mr. Aesoph's audit team to perform this type of procedure.

First, loan loss estimates are the responsibility of management, not the auditors. (J.P.F. ¶¶ 39, 45 (Resp'ts Ex. 61, AU § 342.03) ("Management is responsible for making the accounting estimates included in the financial statements.").) Mr. Aesoph and the audit team, meanwhile, were charged with evaluating whether TierOne's estimation process was *reasonable*. (J.P.F. ¶ 78.) They could not impose on the Bank any particular methodology for estimating losses on impaired loans. (J.P.F. ¶ 39 (Resp'ts Ex. 52, AU § 110.03) ("[T]he auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them.").)

[13] The Division also claimed that "[t]he auditors did not perform some sort of significant FAS 157 analysis to discount market indices or disregard appraisals." (Tr. 2305:11–13 (Division's Counsel).) In making this allegation, the Division appears to assume that the analysis in the L-30A memorandum was performed without any consideration of FAS 157. That assumption is directly contrary to the evidence in this case. For example, Ms. Johnigan testified that the L-30A memorandum's discussion of liquidation appraisals and foreclosures was "absolutely" a "recognition of the provisions of FAS 157." (J.P.F. ¶ 376 (Tr. 2062:2–10 (Johnigan)).) She explained, "I don't know why else they would have written it." (J.P.F. ¶ 376 (Tr. 2062:10–11 (Johnigan)).)

Second, the auditors understood that the declines in the market price indices for areas like Nevada and Arizona *overstated* declines in fair values. (J.P.F. ¶¶ 150, 154, 157.) Because TierOne's impaired loan losses were similar in magnitude to even *unadjusted* indices, the overall loss recognition numbers provided assurance that TierOne's loss estimates were not unreasonably low. There was no need for Mr. Aesoph and Mr. Bennett to go through the process of trying to remove the effect of distressed sales, when the result undoubtedly would have been a smaller decline in fair values.[14]

Ultimately, the Division's effort to reduce the 2008 audit to a handful of loans and a raw price index is an effort to redefine what auditors are supposed to do. The auditors' objective was to determine whether the loan losses TierOne had recognized at year-end were, in the context of the financial statements taken as a whole, reasonable. Those estimates were inherently imprecise and subject to Level 3 inputs under FAS 157. No one piece of data, such as an index of market prices, could substitute for the comprehensive audit procedures Mr. Aesoph and his team planned and performed.

---

[14] And, in any event, adjusted indices like those that Professor James relied upon to form his opinions capture only a portion of the kinds of distressed sales that overwhelmed the markets in Nevada and Arizona in 2008. (J.P.F. ¶ 505.) As the FASB and the Commission's Office of the Chief Account recognized in 2008, "Determining whether a particular transaction is a forced or disorderly requires *judgment*." (J.P.F. ¶ 59 (Resp'ts Ex. 66, SEC Release No. 2008-234) (emphasis added).) Mr. Barron agreed: "I mean, if you're trying to decide which sale is a forced sale or another sale is not a forced sale, it would require judgment to evaluate that. I mean, sometimes you know because you knew it was a foreclosure sale." (Tr. 1238:14–18 (Barron).) Thus, numerically adjusting market price indices to account for distressed sales—while useful in the context of this litigation to demonstrate the critical errors in Professor Thakor's opinions—still would not have been a relevant test of TierOne's fair value estimates in the context of the 2008 audit. (J.P.F. ¶ 155.) Additional judgments, in the form of Level 3 inputs, would still have been required.

5. The Division's allegations of management bias ignore the numerous examples in the audit record that refuted bias.

A central theme of the Division's case is that Mr. Aesoph and his team disregarded evidence of bias in TierOne's loan loss estimates. Mr. Barron testified that "there is evidence of possible bias. And I didn't see evidence that the [auditors] looked at that." (Tr. 2253:2–8 (Barron).) This assertion once again invites the Court to ignore the bulk of the audit evidence. Under AU § 312.36, bias may be present when "the effect of the difference between *each estimate* and the estimate best supported by the audit evidence was to increase income." (J.P.F. ¶ 84 (Resp'ts Ex 84, AU § 312.36) (emphasis added).) The auditors did not observe TierOne's estimates to be biased in favor of avoiding losses. Multiple pieces of audit evidence indicated that other estimates went in precisely the opposite direction.

First, the auditors observed that TierOne had recognized losses of 22% on impaired loans in total and 30% on impaired loans in Nevada. (J.P.F. ¶ 402.) These numbers were consistent with market trends as reported by independent third parties such as Case-Shiller, and those trends *overstated* declines in fair value. (J.P.F. ¶ 376.) TierOne's overall loss recognition on impaired loans was therefore strong evidence of the absence of management bias.

Second, the Bank's estimates on a number of individual loans proved either conservative (HDB and Rodney Kush) or very close to values reported in updated appraisals (Rising Sun). (J.P.F. ¶ 407.) Mr. Barron attempted to establish management bias at the hearing by claiming that the drop in collateral value due to appraisals the Bank later received on its impaired loans was, on average, greater than market declines. He admitted, however, that the picture changed dramatically when he considered what actually mattered to the auditors: the resulting losses after the Bank incorporated the new appraisals into its FAS 114 estimation process. As he explained, when the full loss estimation process is taken into account, "some of [the new appraisals] don't have any effect [on loan losses]. Others have very significant effects." (J.P.F. ¶ 409 (Tr. 1143:5–6 (Barron)).) On average, Mr. Barron conceded, the increase in losses attributable to new appraisals amounted to "9 percent or something on that order, which as Ms. Johnigan pointed out . . . that might be considered consistent with sort of the Case-Shiller model." (J.P.F. ¶ 409 (Tr. 1142:18–22 (Barron)).)

Third, TierOne booked millions of dollars of FAS 5 losses on so-called "Bucket 3" loans—loans considered for impairment but ultimately determined not to be impaired (and therefore not evaluated for loss under FAS 114). Those loans, if accounted for under FAS 114, would have resulted in zero loan losses being recognized on TierOne's financial statements at year-end 2008 because they had excess collateral value. (J.P.F. ¶ 403(c).) Instead, as Mr. Aesoph explained, "[t]here were some very significant loans in this bucket dollar-wise that were reserved for under FAS 5 and carried significant FAS 5 reserves." (J.P.F. ¶ 403(c) (Tr. 986:19–22 (Aesoph)).)

Finally, the auditors' observations from the continuation of TierOne's FAS 114 estimation process in Q3 and Q4 of 2008 confirmed an absence of bias. TierOne deemed 17 loans newly impaired in the second half of the year and obtained 26 new appraisals, most of them in markets that were less disorderly than Nevada during that time. The auditors reviewed the FAS 114 templates for each of these loans at year-end. (J.P.F. ¶ 322.) The Bank's decision to categorize these loans as impaired led to millions of dollars of loan losses booked under FAS 114 in the latter half of the year,[15] including over $10 million in losses in Nevada alone—for

[15] Mr. Barron alleged at trial that a decrease in charge-offs in the second half of the year was a "red flag" that the auditors ignored. (Tr. 2255:2–5 (Barron).) As the Bank's own L-30A memorandum explained, however, this charge-off activity was the result of two causes, neither of which were red flags. First, a large portion of the charge-offs in the first half of the

(Cont'd on next page)

example, the MME loan (which resulted in a $4 million charge-off), HD Tbella (which resulted in a $1.9 million charge-off) and Valley Heights (which resulted in a $6 million loan loss). From the perspective of auditors evaluating TierOne's estimation process, the year-end FAS 114 portion of TierOne's ALLL appeared to be unbiased.

The Division's theory of management bias is therefore much like its overall approach to this case. Rather than presenting the entire body of evidence, the Division cherry-picks numbers that appear to support its arguments, using its audit expert to claim that these isolated data points reveal unprofessional conduct on the part of Mr. Aesoph and Mr. Bennett. The record as a whole refutes the Division's characterization of the audit and demonstrates that Mr. Aesoph in fact complied with all applicable professional standards. The Division's criticisms of the substantive audit procedures are groundless.

B. The controls identified and tested by Mr. Aesoph and his team addressed the risk of overvaluation of FAS 114 loan collateral.

According to the Division, Mr. Aesoph and his team identified "only one control" to address the risk of the overvaluation of collateral underlying TierOne's impaired loans. (Tr. 2302:4–10 (Division's Counsel).) And, in the Division's view, that particular control was ineffective in meeting the control objective. (*Id.*) These allegations are once again the result of cherry-picking from the work papers, and they mischaracterize the procedures the auditors in fact performed.

(Cont'd from previous page)

year related to the Transland loan portfolio, which consisted of loans purchased from a servicer that had engaged in a fraud against TierOne in 2007. Those loans were not analyzed under FAS 114 and are not the subject of the Division's allegations in this case. Second, a majority of the large loans originated in Nevada were deemed impaired in the first and second quarters of 2008, resulting in significant loss recognition at that time. (Resp'ts Ex. 8, L-30A Memo, KPMGTO 5433.)

Attached to this brief as Exhibit D is a chart illustrating the FAS 114 estimation process at TierOne, with key controls identified in red boxes. Ms. Johnigan discussed this chart in her testimony, and the Court admitted it into evidence without objection from the Division. (J.P.F. ¶ 251.) As Ms. Johnigan testified and the work papers confirm, the auditors tested *every* control depicted in the chart.[16] (J.P.F. ¶ 250; Tr. 2014:5–17:15 (Johnigan).)

Mr. Barron asserted at trial that of the multiple controls the auditors identified and tested, only one of them "address[ed] the risk of overvaluation of collateral": the "Appraisal Review" control, documented at work paper L-8. (Tr. 1074:25–75:1 (Barron).) But that control (which is represented in Ms. Johnigan's chart as part of the box entitled "Appraisal / Collateral Reviewed") was just one element of a control environment that ultimately fed into the Asset Classification Committee, the entity responsible for advising the TierOne Board of Directors on the adequacy of the ALLL and each underlying FAS 114 estimate. As Mr. Bennett explained, "the [Appraisal Review] control" identified by Mr. Barron "is focused on the front end." (J.P.F. ¶¶ 273–75 (Tr. 492:1–2 (Bennett)).) It was not designed as a substitute for back-end controls in which individual FAS 114 estimates were reviewed and evaluated.

Ms. Johnigan elaborated on this point in her expert report and during her testimony. She explained that the "Appraisal Review" control at work paper L-8 was part of a set of controls that also included the "Collateral Support" control at work paper L-7. (J.P.F. ¶ 270.) These

[16] The chart depicts only a portion of the controls test work. (J.P.F. ¶ 250; Tr. 2014:2–4.) Ms. Johnigan's expert report, also in evidence, describes other controls tested by the audit team that were relevant to TierOne's FAS 114 loan loss estimation process. For example, the auditors, with the assistance of Information Risk Management specialists, tested the accuracy of loan-specific information that resided in TierOne's electronic systems. (J.P.F. ¶ 270 (Resp'ts Ex. 42, Johnigan Report at 46 & n.185).) This information was compiled into various reports the ACC reviewed to conclude on the reasonableness of loan loss estimates. (*Id.*)

controls were "very specific" and were intended "to make sure that the appraisals that [came] into the process [were] relevant, reliable data." (J.P.F. ¶ 270 (Tr. 2014:5–9 (Johnigan)).) The controls were designed to confirm that the appraisers the Bank relied upon were independent, "the information that the appraiser [was] using in his assumptions [was] reasonable," and "the data [was] in the loan file." (J.P.F. ¶ 273 (Tr. 2015:10–16 (Johnigan)).) Thus, these controls fulfilled a specific function: they addressed the reliability of inputs that would later be used in the FAS 114 estimation process.

Indeed, another control—which Mr. Barron omitted from his expert report and never mentioned during his direct testimony—was specifically designed to evaluate TierOne's loan-by-loan FAS 114 estimates. That control is depicted in Ms. Johnigan's chart as "Finance Department (Controller) Reviews FAS 114 Templates." The work papers explain the details of the control, noting that individual FAS 114 templates at TierOne were prepared in the first instance by Credit Administration personnel under direction of the Special Assets Executive, who signed them as "Preparer." (J.P.F. ¶ 279 (Resp'ts Ex. 2A, Mgmt. Binder, KPMGTO 3027)).) Once prepared, the templates were provided to the Finance Department, *i.e.*, the Controller, Mr. David Kellogg. (*Id.*) As the representative of the Finance Department, Mr. Kellogg was responsible for approving the templates and signing them as "Reviewer." (*Id.*)

This was a significant process. In Ms. Johnigan's description, Mr. Kellogg's review of individual FAS 114 templates was a "strong control": "another separate party [was] looking at it and seeing all the information that was used, and concurring on the method that was used and the amounts that were arrived at." (J.P.F. ¶ 280 (Tr. 2022:13–17 (Johnigan)).) Through this loan-by-loan review, Mr. Kellogg—acting independently of the Credit Administration Department—addressed the risk of collateral overvaluation. (J.P.F. ¶ 280.) Mr. Barron himself conceded that "review of the supporting documentation by someone other than the group that actually did the estimation could have been an effective control." (J.P.F. ¶ 280 (Tr. 1095:9–12 (Barron)).) He further admitted that Mr. Kellogg would have been an appropriate person to conduct that review. (J.P.F. ¶ 280.)

Importantly, Mr. Kellogg was a member of the Asset Classification Committee, and he brought to the ACC "his knowledge of having reviewed the FAS 114 [templates] . . . and . . . the data surrounding them." (J.P.F. ¶ 287 (Tr. 2026:4–14 (Johnigan)).) Through two separate audit procedures documented at work papers L-2 and L-6, the auditors tested both the ACC and Mr. Kellogg's key role in the estimation process. (J.P.F. ¶¶ 277-278.) The work papers document the importance of Mr. Kellogg's familiarity with individual FAS 114 estimates: he informed the auditors that "discussions at the Asset Classification Meetings have become more focused on what is happening within the loan portfolios . . . . He also noted that the committee discusses . . . FAS 114 impairments." (J.P.F. ¶ 285 (Resp'ts Ex. 7, Work Paper L-6, KPMGTO 5076).)

The auditors confirmed this description of the ACC's function by inspecting "documents and records," including minutes of the ACC's meetings and, as stated in the L-6 work paper, various detailed reports the ACC reviewed in those meetings. (*Id.*) Mr. Bennett explained at the hearing that the auditors inspected these reports "so that we could understand what management was reviewing at year-end as part of our audit." (J.P.F. ¶ 286 (Tr. 1587:24–88:1 (Bennett)).)[17] The reports, an example of which was admitted as Division's Exhibit 108, contained information specific to individual loans. Ms. Johnigan described at the hearing how these reports provided

[17] As documented in the B-8 work paper, the reports forwarded to the ACC "identify potential losses, recommended charge-offs and actual losses." (J.P.F. ¶ 298 (Resp'ts Ex. 3, Work Paper B-8, KPMGTO 3636).) Also documented at that location is the fact that the auditors "corroborated [their] findings with these reports." (*Id.*)

the necessary details: "You've got the risk rating, . . . you've got the balance, available balance on this loan. You've got . . . the amount that's committed on the loan. Then you've got information about its rating. . . . And then you keep going and you see the appraised value. Appraisal date. And then you come to information about it where it's been paid to October of '08 and it was a Transland modification." (J.P.F. ¶ 291 (Tr. 2027:10–21 (Johnigan)).)[18] Ms. Johnigan explained, "It's enough information to get a sense of what is happening with the loan." (J.P.F. ¶ 291 (Tr. 2030:15–16 (Johnigan)).)

Mr. Barron asserted at trial that the ACC did not review individual impaired loans and evaluated only "the ALLL . . . on a combined basis, the ALLL in total, if you will." (Tr. 1076:10–12 (Barron).) The detailed reports that the ACC relied upon—the same reports the auditors inspected as part of their test work—refute Mr. Barron's allegations. And the meeting minutes documented in the work papers eliminate any doubt as to the ACC's role. Those minutes state that the ACC reviewed the detailed information contained in the various reports in order to "conduct[ ] an Asset Review for any changes to Specific and General Reserves." (J.P.F. ¶ 288 (Resp'ts Ex. 7D, Work Paper L-2, KPMGTO 5058).) Only after the ACC reviewed the reports did it conclude "there would be no changes to Specific or General Reserves at this time." (*Id.*) Combined with the expertise of Mr. Kellogg—who was "intimately aware of the 114 calculation" (J.P.F. ¶ 287 (Tr. 2026:14 (Johnigan)))—the reports provided the ACC with information sufficient to fulfill its function and address the risk of the overvaluation of loan collateral. (J.P.F. ¶ 301.)

---

[18] Mr. Barron confirmed this description of the reports during his own testimony, and he also confirmed that the impaired loans at issue in this case were among those included in the reports. (J.P.F. ¶ 293 (Tr. 1269:11–71:5, 1276:10–77:9 (Barron)).)

The Division's criticisms are therefore based on a mistaken premise—that "Appraisal Review" was the only control at TierOne designed to address the risk of collateral overvaluation and the consequent risk that FAS 114 loan loss estimates might be too low. Mr. Aesoph and his team, unlike the Division, did not evaluate TierOne's controls in isolation. Instead, they evaluated each control in context, as the auditing standards contemplate. (J.P.F. ¶ 249; *see* Resp'ts Ex. 50, AS No. 5 ¶ 41 ("The decision as to whether a control should be selected for testing depends on which controls, *individually or in combination*, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled . . . .") (emphasis added).) The work papers plainly demonstrate that the "Appraisal Review" control was just one element of a process at TierOne that addressed the risk that the "ALLL is improperly valued." (J.P.F. ¶ 245 (Resp'ts Ex. 8A, Work Paper L (Audit Program) KPMGTO 5188).) The auditors understood how each of TierOne's controls, working together, effectively addressed the risk of misstatement at the financial statement level—precisely what the auditing guidance required of them.

C. The audit team fully satisfied the documentation standards of AS No. 3.

While audit documentation is referenced in the OIP, the Division chose to ignore it completely in its Opening Statement—never once focusing on it as an alleged audit failure. In its closing argument, however, the Division changed course, portraying audit documentation as one of the central issues in this proceeding. (Tr. 2283:15–84:24.) In doing so, the Division asserted that "[a]uditors have an *unconditional* requirement to document their work." (Tr. 2284:5–6 (Division's Counsel) (emphasis added).) This position is once again based on a distortion of the auditing guidance.

The relevant standard, AS No. 3, states that auditors must "document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions." (J.P.F. ¶ 106 (Resp'ts Ex. 49, AS No. 3 ¶ 6).) Here, there is no question that the auditors documented their procedures over the relevant financial statement assertion, the ALLL. But the Division goes further, challenging the specific *content*—indeed, the specific *wording*—of the documentation and suggesting that its sufficiency is to be tested by examining isolated excerpts from a few hand-selected work papers, and comparing them to the Division's post-hoc allegations. The Division is wrong.

1. AS No. 3 acknowledges that the specific content of audit documentation is a matter of professional judgment and is calibrated to the relevant financial statement assertion.

The sufficiency of documentation is assessed from the standpoint of "an experienced auditor" with "a reasonable understanding of audit activities." This guidance assumes that this "experienced auditor . . . has studied the company's industry as well as the accounting and auditing issues relevant to the industry." (J.P.F. ¶ 107 (Resp'ts Ex. 49, AS No. 3 ¶ 6).) Documentation under AS No. 3 is not a game of "gotcha." While the question of *whether* to document audit procedures is not up for debate, the particular *content* and *wording* of the documentation for any given audit is a matter of professional judgment. Ms. Johnigan, quoting directly from the professional standards, testified that "Auditors exercise professional judgment in nearly every aspect of planning, performing and reporting on an audit. Auditors also exercise professional judgment in the documentation of an audit and other engagements." (J.P.F. ¶ 108 (Tr. 2060:12–16 (Johnigan)).) She explained that "if you were trying to record everything you did, it would be totally impractical. There's so many things that are done. There are so many computations that are done. You have to make a judgment as to what do you need to put in the work papers to demonstrate that you have enough evidence to come to your conclusion . . . ." (J.P.F. ¶ 109 (Tr. 2061:3–10 (Johnigan)).)

The Division apparently assumes that the audit documentation should have included information sufficient to show that Mr. Aesoph and his team formed particularized opinions on individual loans. But that was not the objective of the audit. Mr. Aesoph explained, "we [we]re assessing the adequacy of allowance for loan loss; that's our responsibility. We're not opining on individual loans. . . . We're not opining on any individual credit." (J.P.F. ¶ 85 (Tr. 866:12–16 (Aesoph)).) The guidance states that documentation must be calibrated "to *relevant financial statement assertions*." (J.P.F. ¶ 106 (Resp'ts Ex. 49, AS No. 3 ¶ 6) (emphasis added).) Here, the relevant financial statement assertion is the ALLL, in the context of the financial statements taken as a whole—the assertion is not the treatment of individual non-homogeneous loans that were, or had the potential to be, evaluated under FAS 114. (J.P.F. ¶ 78; *see also* Resp'ts Ex. 61, AU § 342.04 (auditors are "responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole").) .

The documentation in this case demonstrates that the auditors carefully addressed the relevant financial statement assertion, the ALLL, and tested each part of the estimation process under AU § 342.10, including the FAS 114 portion. Ms. Johnigan—a highly experienced auditor who has "studied the . . . industry" (Resp'ts Ex. 49, AS No. 3 ¶ 6) for much of her 40-year career—explained, "I can see that appraisals were reviewed, loan files were reviewed, interim credit reviews were reviewed, the data that supports conclusions were reviewed." (J.P.F. ¶ 361 (Tr. 2040:18–21 (Johnigan)).) She concluded that the documentation sufficiently demonstrated that "*the process was reviewed and tested.*" (J.P.F. ¶ 361 (Tr. 2040:19 (Johnigan)) (emphasis added).)

2. The documentation of the auditors' FAS 114 procedures included more than a two-page memorandum.

The documentation for the year-end 2008 audit of TierOne spanned 7,000 pages and 19 binders. (J.P.F. ¶ 435.) As Ms. Johnigan testified, "The work papers are of a whole." (J.P.F. ¶ 439 (Tr. 2042:17 (Johnigan)).) She agreed that it would be inappropriate "to focus on one work paper and ignore all other documentation regarding the financial statement assertion." (J.P.F. ¶ 439 (Tr. 2042:10–15 (Johnigan)).) That, however, is exactly what the Division would have this Court do. The Division focuses its criticisms on a single two-page memorandum, work paper reference L-32, when the audit documentation was much more.

The suggestion that the L-32 memorandum reflects the entirety of the auditors' FAS 114 procedures ignores hundreds of pages of documentation that the auditors undisputedly considered. Much of that documentation is described at section III.A.3, *supra*. It includes the 38-page L-30A memorandum, which discussed market data and economic information bearing on the bank's FAS 114 loan loss estimates. It includes 137 pages of credit file reviews conducted by the credit risk specialist and others. It includes over forty pages of data that the auditors analyzed to understand trends in the loan portfolio, including data showing losses on impaired loans in each of the Bank's lending markets.

The Division also ignores the considerable amount of information contained in TierOne's loan files, just a third of which consumed 49 bankers' boxes of documents. (J.P.F. ¶¶ 337–38 (Tr. 313:2–4 (Hon. Judge Foelak)).)[19] No one disputed that the auditors reviewed many of those loan files as part of their FAS 114 procedures. (J.P.F. ¶ 335.) And no one suggested that those

[19] The 49 bankers' boxes the Division described at the hearing represented loan files for just one-third of the FAS 114 loans on which the Division's allegations rest. The remainder of the files were unavailable because the Division's investigation failed to obtain them. (J.P.F. ¶¶ 451–54.)

massive loan files should have been retained in the work papers. Mr. Barron admitted, "I would not expect them to take an entire loan file and save it in their work papers." (J.P.F. ¶ 335 (Tr. 1330:5–6 (Barron)).)

Finally, the Division ignores the fact that the L-32 series of work papers is not just a two-page summary memorandum. The bulk of the L-32 series comprises 65 pages of individual FAS 114 templates, containing annotations that demonstrate the auditors' review and judgmental testing of individual loans. Those templates alone contradict the Division's characterization of the audit documentation. In its closing argument, the Division asserted that none of the work papers corroborated Mr. Bennett's sworn testimony that "he was evaluating and inquiring [about FAS 114 loans] regardless of [the] age [of appraisals]." (Tr. 2295:4–5 (Division's Counsel).) In the Division's view, the two-page L-32 memorandum conclusively demonstrated that the auditors "inquired of management" only "if the appraisal was older than a year." (Tr. 2294:2–4 (Division's Counsel).) But several of the FAS 114 templates show that even when appraised values were dated in 2008, the auditors made notations evidencing their conversations with TierOne management, a review of the loan file by the audit team's credit risk specialist, and the auditors' review of the appraisal itself. (J.P.F. ¶¶ 322, 342.) The Division cannot force an unwarranted interpretation of a few lines in a single work paper by inviting the Court to pretend that other portions of the work papers simply do not exist.

3. The auditors' documentation of their conversations with management must be understood in light of data that plainly formed the basis for their conclusions.

According to the Division, "the most striking example" of "procedures that are not documented" is a conversation the auditors had with Controller David Kellogg to discuss the 30% impaired loan losses in Nevada and the fact that this loss percentage was consistent with the took place during the audit, this one with OTS Field Manager Douglas Pittman. During the first week of the hearing, the Division questioned Mr. Bennett's description of a phone call he and Mr. Aesoph held with Mr. Pittman, suggesting that during the call Mr. Pittman did not inform the auditors that TierOne's responses to the OTS's regulatory requests were "effective." Mr. Bennett testified, "I'm not sure effective was the term. The term that I used was 'satisfactory.' So I guess I'll agree with you satisfactory means [TierOne was] complying with the responses." (Tr. 427:14–24 (Bennett).) After the two-week recess in the hearing, the Division decided to call Mr. Pittman as a witness. His testimony unambiguously corroborated Mr. Bennett's recollection of their conversation:

> Q: You told [Mr. Bennett] and Mr. Aesoph that management was *complying with the requirements* to submit additional information, right?
>
> A: Yes.
>
> . . .
>
> Q: You told [Mr. Bennett] and Mr. Aesoph that management was *appropriately addressing concerns* raised in the ROE, correct?
>
> A: Yes.
>
> Q: And you told [Mr. Bennett] and Mr. Aesoph that you believed management *had the ability to address the issue identified by OTS*, correct?
>
> A: That's correct.

(J.P.F. ¶ 206 (Tr. 1457:25–58:19 (Pittman) (emphases added)).) The Division's arguments about documentation turn out to be little more than an attempt to do indirectly what it cannot do directly: attack the auditors' credibility. And this exchange with Mr. Pittman proves

Mr. Bennett is credible—just as the record as a whole shows that both Mr. Aesoph and Mr. Bennett have been forthright throughout this entire proceeding.[21]

Diversions about credibility aside, the Division misses the point of the Kellogg conversation and its relation to the auditors' procedures. As Mr. Aesoph testified, "I thought that the test work we did on the FAS 114 loans stood on its own." (J.P.F. ¶ 373 (Tr. 1784:24–25 (Aesoph)).) In other words, the Kellogg conversation merely confirmed the information that was already in the work papers; there was no need to reiterate it.

The Kellogg conversation, like other similar conversations, is documented at two locations in the L-30 work paper, which is the memorandum explaining the auditors' overall conclusions on the ALLL. That memorandum states that when the auditors met with management they discussed "significant trends in delinquencies, changes in loan assessments and ratings, and credit issues" and "whether there are other properties in which [TierOne] believe[s] additional reserves are necessary under FAS 114." (J.P.F. ¶¶ 314, 373 (Resp'ts Ex. 8, Work Paper L-30, KPMGTO 5425, 5428)).) Meanwhile, the L-30A memorandum identifies the market indices that TierOne considered in making its loan loss estimates, among them Case-Shiller. (J.P.F. ¶ 374 (Resp'ts Ex. 8, L-30A Memorandum, KPMGTO 5436)).) Finally, the L-37 work paper documents the 30% loss figure for Nevada.[22]

---

[21] Indeed, the auditors testified for fourteen days during the investigation phase, although the Division only requested a fraction of that number. (Tr. 1519:16–20:1 (Bennett) ("If I recall, the subpoena originally said about two days. And so [I, Mr. Bennett,] decided to do the remaining eight days as voluntary.").) Mr. Aesoph and Mr. Bennett have continually sought to provide the Division with all information relevant to this case in the spirit of full disclosure and full cooperation. The suggestion that they have been anything but honest is baseless.

[22] The 30% figure is the result of a simple calculation, obvious to any auditor with "a reasonable understanding of audit activities." (J.P.F. ¶ 107 (Resp'ts Ex. 49, AS No. 3 ¶ 6).) Mr. Barron confirmed that an auditor could perform the calculation as a matter of routine. (Tr. 1364:23–65:2 (Barron).) Ms. Johnigan, a highly experienced auditor knowledgeable

(Cont'd on next page)

An experienced auditor, familiar with TierOne's industry, would understand the relevance of this 30% figure and its relation to the market data described in L-30A. Indeed, the very purpose of L-37, as stated in its cover memorandum, was to "assess whether there are significant loans in certain states and regions that should be further scrutinized for valuation or impairment *given the continued deterioration in real estate values and financial markets in general*." (J.P.F. ¶¶ 355, 394 (Resp'ts Ex. 8, Work Paper L-37, KPMGTO 5574) (emphasis added).) As Mr. Aesoph explained, "the specific reason" why the auditors included the L-37 series in their documentation "was to track what was happening on a state-by-state basis with this company." (J.P.F. ¶ 355 (Tr. 1788:6–11 (Aesoph)).) The Division conceded in its closing argument that, under the professional guidance, an auditor need not document "every single conversation or every single thing you look at during the audit." (Tr. 2284:12–15 (Division's Counsel).) Yet the Division simultaneously attempts to criticize the auditors for employing the kind of professional judgments that AS No. 3 contemplates.

Rule 102(e) is an improper vehicle to second-guess auditor judgments as to the specific *content* of audit documentation. Allegations of documentation deficiencies have typically involved either egregious misconduct such as work paper fabrication or back-dating, *Chisolm*, Exchange Act Rel. No. 64279, 2011 WL 1341148, at *5 (Apr. 8, 2011), or a complete *absence* of documentation, calling into question whether the auditors "devote[ed] substantial, *or any*, effort to review the areas in question." *Hall*, Exchange Act Rel. No. 61162, 2009 SEC LEXIS 4165, at *9 n.37 (Dec. 14, 2009) (citing *Dearlove*, 92 SEC Docket 1867, 1883 n.39 (Jan. 31, 2008))

(Cont'd from previous page)

about TierOne's industry, testified that "I want evidence that I can understand as an experienced reviewer. . . . And [the 30% figure] seems very apparent on its face, to me." (J.P.F. ¶ 437 (Tr. 2104:23–05:2 (Johnigan)).)

(emphasis added). Those kinds of documentation failures may reveal a threat to the Commission's processes; the detailed and voluminous documentation here does nothing of the kind.

D. In the context of TierOne's $93 million pre-tax loss in 2008, an additional $4.2 million in loan losses in the first quarter of 2009 did not trigger AU § 561.

The Division has all but abandoned its charge under AU § 561. Although the Division discussed the charge in its opening statement, it was not mentioned even once during closing argument, even during the Division's rebuttal. The reason for this about-face is apparent from the record. The evidence refutes the Division's AU § 561 theory.

The appraisals that are the subject of the Division's AU § 561 allegations resulted in additional loan loss provisions of approximately $4.2 million[23] in the first quarter of 2009. (J.P.F. ¶¶ 422–423.) This amount was chiefly the result of losses on two loans, MME and Celebrate 50, both of which the auditors had assessed on multiple occasions in 2008, and both of which the Bank had written down significantly throughout that year—indeed, in some quarters in 2008, the losses on those loans were greater than the losses TierOne booked in the first quarter of 2009. (J.P.F. ¶ 422.) It was obvious to Mr. Aesoph, as it would have been to any experienced auditor, that those appraisals would not have "affected the [audit] report" had he been aware of them before the close of the 2008 financial statements. (J.P.F. ¶ 414 (Resp'ts Ex. 63, AU § 561.01).) TierOne's 2008 financial statements reflected a $93 million pre-tax loss. (J.P.F. ¶ 423.) "[O]n its face, [an additional $4.2 million in losses] would not have been material to the

[23] As the Division conceded at trial, the $4.2 million figure is the result of netting out the effect of another appraisal—one that the OIP neglects to mention and is nowhere to be found in Mr. Barron's report. TierOne received this appraisal, like the others, in early 2009. It showed a substantial *increase* in collateral value. (J.P.F. ¶ 419.)

financial statements taken as a whole at the end of December 31st, 2008." (J.P.F. ¶ 423 (Tr. 2050:12–14 (Johnigan)).) AU § 561 therefore did not apply. Nor did it require, as the Division has alleged, any detailed analysis.

Even Mr. Barron did not dispute that the additional losses were immaterial. He testified, "I'm not really opining on whether they should have restated the financial statements." (J.P.F. ¶¶ 424 (Tr. 1159:8–9 (Barron)).) Instead, he cited the $1.9 million materiality threshold the auditors developed during the planning phase of the audit and suggested that Mr. Aesoph and Mr. Bennett should have "sat down with management and had a discussion about having the need to restate the financials or recall [the] opinion and all that." (J.P.F. ¶ 424 (Tr. 1159:11–20 (Barron)).)

Mr. Barron confuses materiality judgments made for purposes of *planning* an audit with materiality judgments used to assess the accuracy of the *financial statements*. The guidance is explicit on this point. "The auditor's *preliminary judgment* about materiality *ordinarily will differ* from the judgment about materiality used in evaluating the audit findings." (J.P.F. ¶ 426, (Resp'ts Ex. 57, AU § 312.22 (emphasis added)).) Materiality in the context of the financial statements is "a matter of professional judgment and is influenced by [an auditor's] perception of the needs of a reasonable person who will rely on the financial statements." (J.P.F. ¶ 426 (Resp'ts Ex. 57, AU § 312.10).) There is no set formula. Mr. Barron is simply wrong when he suggests that the numeric planning-phase materiality threshold is the test for whether the auditors should have "sat down with management and had a discussion" about AU § 561. (J.P.F. ¶ 426 (Tr. 1159:12–20 (Barron)).)

Ms. Johnigan, unlike Mr. Barron, understood the distinctions the audit literature draws between materiality for planning purposes and evaluating whether the financial statements present fairly, in all material respects, a company's financial position in conformity with GAAP. She explained that materiality thresholds set during audit planning are intended to ensure that auditors "test[ ] at a low enough level"; they are "not the same materiality used when you discuss the financial statements taken as a whole as to whether there are material effects." (J.P.F. ¶ 426 (Tr. 2051:10–20 (Johnigan)).) Here, there is no suggestion, nor could there be, that an additional $4.2 million loss—in the context of the $93 million loss reported by TierOne for the 2008 fiscal year—would have been material to a reasonable person relying on the financial statements. (J.P.F. ¶ 423–24, 426.) The new appraisals TierOne received in 2009 did not "affect[ ] the [audit] report" under AU § 561 (J.P.F. ¶ 424 (Tr. 2050:17–51:1 (Johnigan)))—the Division has no basis for this charge.

III.
THE DIVISION'S EXPERTS LACK CREDIBILITY AND THEIR OPINIONS ARE ENTITLED TO NO WEIGHT

Every witness in this matter—aside from the Division's two experts—confirmed that the auditors complied with professional standards and pose no threat to the Commission's processes.[24] The Division's case therefore rests entirely on the testimony of its two expert witnesses, Mr. John Barron and Professor Anjan Thakor. Those witnesses, however, were not credible. Both ignored crucial facts. Both misstated or misapplied basic accounting concepts central to the year-end 2008 audit. The Court should afford their testimony no weight.

[24] The testimony of OTS Field Manager Douglas Pittman, the only non-party fact witness that the Division called, confirmed the auditors' description of their conversation with him as part of the audit. (J.P.F. ¶ 206.) Mr. Barron conceded that this conversation demonstrated due care. (J.P.F. ¶ 204.) Nothing in Mr. Pittman's testimony supports the allegation that Mr. Aesoph or Mr. Bennett violated Rule 102(e).

A. Mr. Barron admittedly declined to consider evidence and accounting principles that were central to the auditors' conclusions.

Mr. Barron, the Division's audit expert, has admitted in sworn testimony that he makes his living by criticizing accountants. (J.P.F. ¶ 464 (Tr. 1183:11–22 (Barron)).) In fact, as Mr. Barron conceded at trial, every time he has been retained as an audit expert, he has "ended up criticizing the audit work." (J.P.F. ¶ 464 (Tr. 1184:5–11 (Barron)).) His bias is apparent. In devising opinions about the conduct of Mr. Aesoph and Mr. Bennett, Mr. Barron took inexcusable short cuts.

1. Mr. Barron ignored information he conceded was relevant to his opinions, including information in TierOne's loan files.

Mr. Barron conceded that he did not review all of the work Mr. Aesoph and Mr. Bennett performed as part of the year-end 2008 audit. He testified that, in his view, he was able to "opine on whether or not [the auditors] met professional standards without considering the entirety of the audit work that was done." (J.P.F. ¶ 470 (Tr. 1197:12–16 (Barron)).) This approach stands in stark contrast to Ms. Johnigan's, who explained that in a matter such as this one, "you can't, in my view, appropriately review the work without reviewing *all of it*." (J.P.F. ¶ 439 (Tr. 2042:20–22 (Johnigan) (emphasis added)).)

Under Mr. Barron's selective approach, he ignored a substantial body of evidence that the auditors referenced in their work papers and undeniably consulted: the loan files. Even Mr. Barron had "no doubt that the auditors, Mr. Aesoph and Mr. Bennett, reviewed the loan files." (J.P.F. ¶ 482 (Tr. 1326:16–18 (Barron)).) He also conceded that if he were auditing TierOne, "the loan file is one of the first places [he would] go to get some corroborating evidence." (J.P.F. ¶ 482 (Tr. 1204:20–05:1 (Barron)).) According to Mr. Barron, "Yes. I'd want to look at the loan files, certainly." (J.P.F. ¶ 482 (Tr. 1204:20–05:1(Barron)).) He even conceded that information in the loan files might have affected his expert opinions, had he reviewed them. (J.P.F. ¶ 483 (Tr. 1204:9–13 (Barron)).)

Mr. Barron, however, did not consult the loan files. He did not even ask for them from the Division. (J.P.F. ¶ 483 (Tr. 1321:10–11 (Barron)).) And when Mr. Barron was confronted with documents from TierOne's loan files during cross-examination, he admitted that they did, in fact, change his conclusions—the documents demonstrated that opinions contained in his expert report were *wrong*:

> Q: Mr. Barron, you made that assertion regarding corroboration . . . and that assertion was wrong?
>
> A: You know, I—well, let me think about it a second. Yeah, that assertion was in the appraisal. And according to this they agreed in the appraisal report. Those numbers were in the appraisal report, *I agree with that.*

(J.P.F. ¶ 484 (Tr. 1342:16–25 (Barron) (emphasis added)).)

The Division tried to explain away Mr. Barron's concessions[25] in its closing argument, implying that the loan files are irrelevant because they were "not once opened" during trial. (Tr. 2365:21–24 (Division's Counsel).) That is simply inaccurate. Seventy-one of Respondents' joint exhibits contained either full copies of individual loan files or excerpts of them. The Court admitted seven of those exhibits into evidence, some of which were used as the basis for the

[25] The Division also attempted to rehabilitate Mr. Barron's testimony by requesting that he review a number of appraisals during the two-week intermission between the first and second weeks of the hearing. (Tr. 2216:13–15 (Barron).) After an objection from counsel for Mr. Bennett, joined by counsel for Mr. Aesoph, the Division agreed not to question Mr. Barron about those newly-reviewed appraisals because Mr. Barron did not disclose in his expert report that he considered them in forming his opinions. (Tr. 2217:1–20 (Barron).)

above-mentioned cross-examination of Mr. Barron.[26] The Division cannot repair the damage to Mr. Barron's credibility by asking the Court to disregard the evidence that discredits him.

2. Mr. Barron ignored or misrepresented accounting principles in his report and during his testimony.

Mr. Barron's lack of credibility was not limited to his disregard of relevant factual information. It also extended to his treatment of accounting principles.

In his entire 131-page expert report, not once did Mr. Barron mention that an "orderly transaction" under FAS 157 excludes forced transactions such as distressed sales or liquidations.[27] In fact, in quoting what he described as the "key provisions" of FAS 157, Mr. Barron inserted an ellipsis in place of this crucial language. (J.P.F. ¶ 479; Div. Ex. 211 (Barron Report at 22–23).) It is obvious, though, that he understood this concept before he

[26] It would have been impractical to use entire bankers' boxes full of documents during witness testimony, just as it was impractical to include the loan files in the work papers—something Mr. Barron himself conceded. (J.P.F. ¶ 434 (Tr. 1224:9–17, 1330:5–6 (Barron)).) Thus, in cross-examining Mr. Barron, counsel for Mr. Aesoph instead used electronic versions of exhibits containing pertinent portions of the loans files, leading to the admissions discussed above.

[27] Buried in a footnote on page 86 of his report, Mr. Barron stated, "FAS 157, ¶ 5 defines fair value as 'the price that would be received to sell an asset . . . in an orderly transaction between market participants at the measurement date.' To the extent that a current transaction represented a forced sale, an independent appraiser would be in the best position to consider the implications of this information in arriving at estimated fair value and render an impartial assessment." (Div. Ex. 211, Barron Report at 86 n.279.) But Mr. Barron again omitted from this footnote any reference to FAS 157 ¶ 7—the portion that defines the concept of an "orderly transaction" and explains that it *excludes* forced sales from the fair value analysis. Nor did Mr. Barron cite any authority for his opinion that appraisers—who are not accountants—are in the "best position" to conduct fair value analyses under GAAP. Professor Chris James, on the other hand, cited several studies showing that appraisers were in fact *not* well positioned to apply the definition of fair value in 2008. There were several significant problems with appraisals during the financial crisis, "the biggest problem being that comparables for new single-family homes were *too often based on foreclosures and distressed sales*." (J.P.F. ¶¶ 506–07; Resp'ts Ex. 43A (James Report ¶ 32 (emphasis added)).)

formed his opinions in this case: at the hearing he described it as "generally understood" and "nothing new." (J.P.F. ¶ 478 (Tr. 1236:11–21 (Barron)).) Yet when asked why he failed to explain the concept in his report, Mr. Barron testified that he could not "recall specifically." (J.P.F. ¶ 479 (Tr. 2247:5–14 (Barron)).)

Mr. Barron knew, however, that during the 2008 financial crisis, "auditors and others were struggling with how to apply [FAS] 157 in markets where you had deteriorating conditions." (J.P.F. ¶ 480 (Tr. 1236:6–13 (Barron)).) And he knew that the Commission's Office of the Chief Accountant, in conjunction with the Financial Accounting Standards Board, issued guidance in 2008 specifically to address this confusion by emphasizing that "disorderly transactions are not determinative when measuring fair value"—although he omitted any reference to this guidance in his report as well. (J.P.F. ¶ 480 (Tr. 1236:22–38:18 (Barron)).) Thus, Mr. Barron understood that a crucial accounting issue in 2008 was the application of FAS 157 in markets increasingly dominated by distressed sales. But without explanation, his expert report, critical of audit work performed during *that very time period*, omits the accounting guidance that directly bears on the issue.[28] His report was therefore based on an incomplete analysis of the relevant GAAP.

[28] Mr. Barron also noted during testimony that FAS 157 is an accounting standard rather than an auditing standard, as if that somehow made it less relevant to the year-end 2008 audit. In the first week of trial, he stated, "Well, 157 is an accounting standard, so it really doesn't address auditing standards." (Tr. 1053:10–11 (Barron).) In the second week of trial, in response to a question from the Court about whether FAS 157 requires auditors to exclude from consideration the effect of distressed sales, he again testified, "Well, of course, FAS 157 is an accounting standard, not an auditing standard." (Tr. 2235:17–18 (Barron).) No one disagrees that FAS 157 is an accounting standard. The auditor's responsibility, of course, is to conduct an audit in order to reach an opinion as to whether the company's financial statement *conform to accounting standards*. (J.P.F. ¶¶ 39, 70.)

Mr. Barron did not limit his inaccurate treatment of accounting principles to FAS 157. He also asserted that the amount of charge-offs on a particular loan "really [was] not relevant" to the reasonableness of the ALLL associated with the loan at year-end. (J.P.F. ¶ 476 (Tr. 1032:16–33:2 (Barron)).) This led to a critical logical discrepancy in his testimony. As he testified, when TierOne charged off a portion of an impaired loan, this "reduce[d] the amount of ALLL that's required at the balance sheet date." (J.P.F. ¶ 476 (Tr. 1032:7–8 (Barron)).) Given this direct relationship between charge-offs and the ALLL, it is difficult to understand how Mr. Barron could believe charge-offs were categorically "not relevant."

Finally, Mr. Barron opined, without any support, that a portion of the losses TierOne booked on its Nevada impaired loans in the first half of 2008 actually "arose" in 2007. (Tr. 1149:7–13, 1151:6–52:9 (Barron).) The evidence says otherwise. Ms. Johnigan explained that the 30% loss recognition that TierOne booked on Nevada impaired loans with collateral deficiencies in 2008 *excluded* losses booked in 2007. (J.P.F. ¶ 477.) Indeed, Mr. Barron conceded he did not "know what [the alleged 2007 portion of the losses] would be"; he was confident only that the total loss TierOne recognized in Nevada in 2008 was "probably . . . less than 30 percent." (Tr. 1150:17–20 (Barron).) That allegation is certainly convenient—unless Mr. Barron can get the 2008 loss figure below 30%, there will be no basis for entertaining his opinion that TierOne's collateral estimates in Nevada were "wholly inconsistent" with market data. (Div. Ex. 211 (Barron Report at 28); *see also* Tr. 1834:14–21, 1836:24–37:5 (James).)

Whatever the source of Mr. Barron's theory, he was unable to cite an accounting principle to support it. As Ms. Johnigan explained, there is none: "[A]ccounting has very specific rules about how you account and measure losses on impaired loans so that we can have consistent accountings throughout the United States. And that accounting requires that you first deem a loan impaired; then you measure it, and that's when it gets recorded, and that's when the loss is recorded in the financial statements." (J.P.F. ¶ 477 (Tr. 1945:2–9 (Johnigan)).) Later in his testimony, Mr. Barron conceded this point. He agreed that the impairment decision by TierOne was "the triggering event for the 114 analysis," and only "when a loan is deemed impaired" was TierOne "required to evaluate it under FAS 114." (J.P.F. ¶ 477 (Tr. 1294:12–19 (Barron)).) Those principles, of course, were precisely the ones that governed TierOne's financial statements and Mr. Aesoph's audit of them. Under the relevant GAAP, there is no basis for Mr. Barron's effort to assign the 2008 losses to 2007.

B. Professor Thakor's interpretation of FAS 157 and his use of unadjusted market price indices contravene GAAP.

Rather than present an accounting expert's testimony to explain the concept of fair value under FAS 157, the Division chose to rely on Professor Anjan Thakor, a non-CPA who neglected to read either of the reports submitted by the two expert accountants in this case. (J.P.F. ¶ 511.) In its closing argument, the Division ignored the testimony of these expert accountants and instead quoted Professor Thakor for the notion that "the market is what the market is" (Tr. 2363:13–14 (Division's Counsel)), suggesting that no matter what the text of FAS 157 states, distressed sales must be considered in making fair value estimates.

For three reasons, Professor Thakor's testimony lacks foundation and is entitled to no weight in the Division's effort to redefine fair value.

First, Professor Thakor is not a certified public accountant and is not qualified to opine on accounting matters. (J.P.F. ¶ 509.) The Court acknowledged this when it observed, "Indeed, he was *not offered or accepted* as an expert in accounting." (J.P.F. ¶ 509 (Tr. 133:25–34:1 (Hon. Judge Foelak)) (emphasis added).) In fact, Professor Thakor did not purport to consider FAS 157 in preparing his expert report: his 241-page report nowhere cites that provision, as he readily admitted in testimony. (J.P.F. ¶ 511.) Nor did he consider, or rely upon, the reports of Mr. Barron and Ms. Johnigan, the two accounting experts who testified in this matter. He admitted that he had not read Mr. Barron's report and had not even seen Ms. Johnigan's report at the time of the hearing. (J.P.F. ¶ 511.) The Division offered Professor Thakor only as "an expert in finance and economic analysis"—he had no basis to opine on the meaning or application of accounting standards. (J.P.F. ¶¶ 509–10 (Tr. 112:1–2 (Division's Counsel)).)

Professor Thakor was permitted to testify on FAS 157 only because counsel for the Division assured the Court that Mr. Barron would later lay the foundation for Professor Thakor's testimony. (Tr. 188:25–89:2, 191:2–24.) But when Mr. Barron did address FAS 157, he contradicted Professor Thakor, explaining, "it's generally understood that forced sales or liquidation sales *really should be excluded* in trying to determine comparable sales for the determination of fair market value. I mean, this is nothing new." (J.P.F. ¶ 498 (Tr. 1236:16–20 (Barron)) (emphasis added).) Professor Thakor's testimony on the meaning of FAS 157 is therefore entitled to no weight. *See WSF Corp.*, 77 SEC Docket 1594, 2002 WL 917293, at *4 (ALJ May 8, 2002) (noting that an expert "offered opinions beyond the scope of his demonstrated experience" that were "not the product of reliable principles or methods").

Second, Professor Thakor's "market forces" theory of FAS 157 directly contravenes the accounting literature. FAS 157 states that an "orderly transaction"—the exclusive benchmark of fair value—"is not a forced transaction (for example, a forced liquidation or distress sale)." (J.P.F. ¶ 55 (Resp'ts Ex. 45, FAS 157 ¶ 7).) This fundamental premise of FAS 157 was confirmed in September 2008, when the Commission's Office of the Chief Accountant and the Financial Accounting Standards Board jointly released guidance reiterating: "The results of disorderly transactions are not determinative when measuring fair value." (J.P.F. ¶¶ 58, 520–21

(Resp'ts Ex. 66, SEC Release No. 2008-234).)[29] At the time the joint guidance was issued—the height of the financial crisis—"the current environment . . . made questions surrounding the determination of fair value particularly challenging." (*Id.*) In other words, the 2008 guidance was issued *precisely because* fair value under FAS 157 was not a simple matter of applying "the forces of the market, whatever that market is," as Professor Thakor proposed. (Tr. 195:20–22 (Thakor).) In any event, Professor Thakor could not recall even having *reviewed* this seminal guidance when he formulated his opinion.

Finally, Professor Thakor's "recalculations" of losses on TierOne's individual impaired loans relied exclusively on raw indices of real estate sales prices. (J.P.F. ¶ 514 (Div. Ex. 191, Thakor Report ¶¶ 346–54).) He "simply took the average across the indices." (J.P.F. ¶ 512 (Tr. 250:7–8 (Thakor)).) He "did not adjust for disorderly transactions." (J.P.F. ¶ 514 (Tr. 252: 25–53:1 (Thakor)).)[30] This approach violated FAS 157 and therefore bears no relevance to the year-end 2008 audit.

Professor Chris James—who, unlike Professor Thakor, applied the definition of fair value in FAS 157 as set forth by an accounting expert, Ms. Johnigan (J.P.F. ¶ 494 (Tr. 1813:19–14:2 (James)))—demonstrated the magnitude of the market upheaval in 2008 and the consequent distortion in Professor Thakor's numbers. By one measure, 58% of home sales in Las Vegas

---

[29] While Professor Thakor could not recall whether he considered the joint guidance in formulating his interpretation of FAS 157, it is clear that he did not even discuss that guidance with the Division when preparing for trial. (J.P.F. ¶ 520.)

[30] Although Professor Thakor conceded that each piece of property—even when compared to properties in the same location—has "its own unique characteristics," he did not attempt to "assess[ ] the actual value of any collateral." (J.P.F. ¶ 515 (Tr. 257:6–58:12 (Thakor)).) As Mr. Barron testified, estimating fair value is "not simply a matter of applying a housing price index." (J.P.F. ¶ 515 (Tr. 1232:7–8 (Barron)).) Professor Thakor's "recalculations" therefore say nothing about the reasonableness of TierOne's loan loss estimates on individual impaired loans, each of which was secured by a unique piece of real estate.

were distressed by the fourth quarter of 2008, as illustrated in Exhibit E to this brief. Professor James explained, "That's the kind of market characteristics that one would typically associate with fire sales." (J.P.F. ¶ 501 (Tr. 1823:21–23 (James)).) Moreover, that number actually *understates* the market disruption. The data Professor James cited include only certain categories of distressed sales—namely, bank foreclosures and short sales, which are relatively easy to identify. (J.P.F. ¶¶ 498, 505 (Tr. 1820:14–19 (James)).) The percentage does not include, for example, sales by recently unemployed home owners who "didn't want their credit rating[s] destroyed" or sales by homebuilders who filed for bankruptcy and were "forced to sell" because "[t]heir banks [were] calling the loans." (J.P.F. ¶ 498 (Tr. 1821:13–22:21 (James)).)

When identifiable distressed sales are removed from the market indices on which Professor Thakor relied for his calculations, the effect is dramatic. Exhibit F to this brief illustrates the overall losses TierOne booked on its Nevada impaired loans with collateral deficiencies (the purple line), compared to both the unadjusted Case-Shiller index (the orange line) and an index that excludes distressed sales (the green line). TierOne's impaired loan losses track the Case-Shiller index closely. Those losses are substantially *greater*, however, than the decline in the index that excludes distressed sales. As Professor James testified, none of the indices is determinative of fair value, but the adjusted index is "closer to what fair value is intended to represent." (J.P.F. ¶¶ 504–05 (Tr. 1839:12–14 (James)).)

Mr. Aesoph and Mr. Bennett were not free to assume, as Professor Thakor did, that unadjusted market prices equated to fair value at the height of the financial crisis. They were obligated to comply with GAAP—including FAS 157—even though "the current environment . . . made questions surrounding the determination of fair value particularly challenging." (J.P.F. ¶ 58 (Resp'ts Ex. 66, SEC Release No. 2008-234).) Because Professor Thakor disregards the portions of FAS 157 that contradict his analysis and assumes away the market conditions that prevailed at the time of the audit, his opinions are irrelevant to this case and are entitled to no weight.[31]

IV.
THE DIVISION CANNOT SATISFY RULE 102(e)

A. Rule 102(e) does not apply to the facts of this case.

1. The Division's allegations amount to nothing more than second-guessing the professional audit judgments Mr. Aesoph and his team made at the height of the financial crisis.

Section II, *supra*, explains that because Mr. Aesoph and Mr. Bennett complied with all applicable professional standards in conducting the year-end 2008 audit of TierOne, there is no factual basis for the Division's Rule 102(e) charges. But even if the Division could prove a violation of professional standards, the Division's charges do not rise to the level of misconduct that warrants sanctions under Rule 102(e).

The Division's allegations reduce to second-guessing professional judgments that the audit team made on the ground in 2008, during the most economically challenging time in recent history. The Division does not allege that Mr. Aesoph or Mr. Bennett missed any significant issues or failed to understand any professional standards, and its audit expert, Mr. Barron, never once testified that the conduct at issue in this case was "highly unreasonable" under Rule 102(e). Indeed, the Division acknowledges that the auditors expanded their audit procedures in 2008 in light of the risks posed by TierOne's ALLL. The Division acknowledges that, at year-end 2008, the auditors reviewed every FAS 114 template and subjected a sample of them to additional

[31] Mr. Aesoph renews his motion to exclude Professor Thakor's testimony and expert report for all the reasons stated in Respondents' *First* Joint Motion in Limine—To Exclude the Report and Testimony of Anjan V. Thakor (Aug. 29. 2013).

procedures. The Division acknowledges that the auditors engaged a credit specialist to assist in reviewing individual loans for the reasonableness of their risk ratings and accrual status, issues that are central to the identification of impaired loans and the development of the ALLL. The Division acknowledges that the auditors tested a number of controls over the ALLL, including the FAS 114 portion. But in the face of these and other acknowledged examples of audit work planned, performed, and documented, the Division posits that more work could have been done, more evidence could have been obtained, and additional documentation could have been created.

It is always true that more work could have been done and more evidence could have been obtained. This is why the professional standards acknowledge that "[a]uditors exercise professional judgment in *nearly every aspect* of planning, performing and reporting on an audit." (J.P.F. ¶ 74 (Tr. 2060:12–16 (Johnigan) (emphasis added).) This is also why the reach of Rule 102(e) is carefully circumscribed to forbid the "subjective second-guessing of auditing judgment calls." *Marrie v. SEC*, 374 F.3d 1196, 1206 (D.C. Cir. 2004). Rule 102(e)'s heightened negligence provisions were "not intended to cover all forms of professional misconduct." Amendment to Rule 102(e), 63 Fed. Reg. at 57165–66. Instead, they encompass only egregious lapses in professionalism evidencing a threat to the Commission's mission of protecting the investing public. *See id.* The Division's proof—including the testimony of its expert, who not once suggested that the conduct at issue here was "egregious," "glaring," or anything close to that type of distant departure from professional standards, *McNeeley*, 2012 WL 6457291, at *15–16—falls far short of this stringent standard.

2. Mr. Aesoph, is a qualified, competent auditor and an asset in the Commission's mission to protect the investing public.

Mr. Aesoph, as audit engagement partner, was ultimately responsible for planning, supervising, and executing the audit and making the professional judgments that supported the audit opinion. As he testified at the hearing, he stands by the audit. He is proud of the work he and his team planned and performed during the unprecedented, turbulent conditions of the financial crisis. (J.P.F. ¶ 14; *see also* Tr. 1748:5–8 (Aesoph).)

Mr. Aesoph was fully qualified for his role. He earned a Bachelor of Science in accounting from the University of South Dakota, graduating magna cum laude and with honors. (J.P.F. ¶ 2.) He has been part of the accounting profession since 1996 and has spent the majority of his career auditing financial institutions. (J.P.F. ¶¶ 3, 7.) In the years leading up to the 2008 audit and during that calendar year, he stayed abreast of developments in the accounting field, focusing on issues that arose with the onset of the credit crisis. (J.P.F. ¶ 4.) As a result of this diligence, from 2006 through 2008 Mr. Aesoph earned more than twice the continuing professional education credits required of him. (*Id.*) He had also developed considerable expertise specific to TierOne by the time of the 2008 audit, serving as senior manager on the TierOne engagement for four years and as the audit partner for two. (J.P.F. ¶ 7.) That experience gave Mr. Aesoph a detailed, cumulative working knowledge of TierOne, the key personnel at the Bank, and the Bank's recent financial performance and accounting. (*Id.*)

Mr. Aesoph is a hands-on partner. He prefers to work onsite, at the offices of his audit clients, rather than from his desk at KPMG. (J.P.F. ¶ 9.) Respondent Darren Bennett, the senior manager of the 2008 audit of TierOne, confirmed this. He described Mr. Aesoph's "quiz time" exercise, a coaching tool Mr. Aesoph uses to evaluate the work of his audit teams and explore whether additional procedures might be warranted. (J.P.F. ¶ 11.) It is this type of close audit supervision that has earned Mr. Aesoph several mentoring awards at KPMG. (J.P.F. ¶ 12.)

Mr. Aesoph's hands-on approach was evident during the 2008 audit. As Mr. Bennett testified, when Mr. Aesoph was onsite he specifically directed his quiz time exercises at the procedures the auditors applied to TierOne's ALLL and FAS 114 templates. (J.P.F. ¶ 11.) When Mr. Aesoph was not onsite, he spoke with Mr. Bennett at least every other day, tracking the progress of the audit and providing feedback and guidance. (J.P.F. ¶ 9.) The Division's audit expert, Mr. Barron, had to admit that Mr. Aesoph accurately understood TierOne's complicated process for estimating its ALLL and all relevant auditing and accounting standards. (J.P.F. ¶ 471.) In other words, Mr. Aesoph had the right tools for the job.

Mr. Aesoph employed those tools diligently throughout the 2008 audit, and he continued to do so until 2010, when he decided—after a careful and deliberate investigation—to cause KPMG to resign as the Bank's independent auditor. That investigation uncovered evidence that TierOne management had hid an internal analysis showing, on a loan-by-loan basis, a very different scope of estimated loan losses than had been disclosed to the Bank's auditors or the public. (J.P.F. ¶ 449.) It later became clear that this conduct by Bank management was part of a collusive fraud that targeted the auditors themselves, among others. (J.P.F. ¶ 450.) The Commission filed complaints against these members of management, explaining, for example, that Don Langford, TierOne's Chief Credit Officer, concealed "available information that would require write-downs or additional reserves on TierOne's impaired loans." (J.P.F. ¶ 442 (Resp'ts Ex. 235, *SEC v. Langford*, ¶ 32).)

Mr. Aesoph's conduct, during both the year-end 2008 audit and the investigation of 2009 and 2010, is not the mark of an accountant who might threaten the Commission's processes. The Division simply cannot meet its heavy burden under Rule 102(e).

B. The Court should reject the Division's attempts at rulemaking by enforcement.

If the Court were to credit the Division's positions in this case and find in its favor, the resulting precedent would lead to a troubling and unlawful expansion of the Division's powers.

The Division's interpretations of auditing and accounting principles in this case contradict the profession's understanding of the relevant guidance. An order in favor of the Division would therefore amount to rulemaking by enforcement,[32] which the Commission itself acknowledged would exceed the scope of Rule 102(e): "The Commission does not seek to use Rule 102(e)(1)(ii) to establish new standards for the accounting profession. The rule itself imposes *no new professional standards on accountants*." Amendment to Rule 102(e), 63 Fed. Reg. at 57166 (emphasis added).

Here, the Division's charges seek to alter existing professional guidance in two areas: (1) auditing standards pertaining to accounting estimates and (2) accounting rules governing fair value.

Auditing Estimates. The Division's allegations, as described during closing argument, rest on the assumption that Mr. Aesoph and his team were responsible for "*auditing* [TierOne's FAS 114] templates on a loan-by-loan basis." (Tr. 2286:6–7 (Division's Counsel) (emphasis added).) Mr. Barron made the same suggestion when he testified, "the only way the auditors can really get reasonable assurance is to . . . essentially, *audit these individual estimates* dealing primarily with collateral valuation." (Tr. 1027:23–28:3 (Barron) (emphasis added).)

---

[32] The Public Company Accounting Oversight Board is the federal entity with authority to promulgate standards governing the auditing profession. 15 U.S.C. § 7213(a)(1). The Division has no role in the rulemaking process, and the role of the Commission itself is limited. *See* § 7217(b)(3); § 7217(b)(5) (incorporating the requirements of § 78s(c)). Accounting principles, meanwhile, are the province of the Financial Accounting Standards Board and the Commission's Office of the Chief Accountant. Any accounting "rule or regulation of general application other than an interpretive rule" must be accompanied by standard notice-and-comment procedures unless the Commission specifically finds that those procedures would be "impracticable, unnecessary, or contrary to the public interest." 17 C.F.R. § 201.192(b). None of these prerequisites to rulemaking has been satisfied here.

Mr. Aesoph did not understand this to be his role as an independent auditor. He testified, "we [we]re assessing the adequacy of allowance for loan loss; that's our responsibility. We're not opining on individual loans. . . . We're not opining on any individual credit." (J.P.F. ¶ 85 (Tr. 866:12–16 (Aesoph)).) Mr. Bennett agreed: "our responsibility is to audit the allowance for loan losses in the context of financial statements taken as a whole. And that's required by standards and includes both FAS 5 and FAS 114 together." (Tr. 576:22–77:1 (Bennett); *see* J.P.F. ¶ 85.) The audit standards confirm that this understanding was correct. Professional auditing standards do not require an independent accountant to audit each assumption used in developing a reserve estimate for an individual loan. (J.P.F. ¶ 97.). The auditor is instead responsible only for assessing the reasonableness of the ALLL in the context of the company's financial statements taken as a whole. (J.P.F. ¶¶ 78, 79, 234.)

Ms. Johnigan testified that if the Division's view were to prevail—that is, if auditors must in fact "audit[ ] at a level lower than the financial statement assertion"—then "the accounting standards would have to be rewritten." (Tr. 2052:19–53:1 (Johnigan).) The Commission is free to pursue such a course through rulemaking, but it has not done so.[33] The Division is not empowered to achieve the same end by applying a previously unrecognized auditing requirement in post-hoc fashion during an enforcement proceeding.

Fair Value Accounting. The Division's allegations would also require re-writing the accounting guidance on fair value. This was made clear during closing argument, when the Division—relying on Professor Thakor's inexpert and demonstrably incorrect opinion of FAS 157—suggested, "It cannot be that fair value measurements say that in a time of unbelievable

[33] And if the Commission so wished, the standard-setting process begins with the PCAOB, not the Division of Enforcement. *See* § 7213(a)(1).

economic decline, collapses in housing prices, you can . . . throw out any bad sale and only look at people who happen to not have any pressure to sell their home." (Tr. 2363:19–24 (Division's Counsel).)

As explained in section III.B, *supra*, the Division's understanding of fair value contravenes FAS 157 and guidance jointly issued by the Financial Accounting Standards Board and the Commission's Office of the Chief Accountant. Based on that explicit guidance, FAS 157 can—and does—mean that in distressed markets, accountants must judgmentally evaluate market conditions and exclude distressed sales from the fair value analysis. Mr. Aesoph, as engagement partner, took full responsibility for the audit work his team planned and performed in 2008, relying on the accounting guidance as it was promulgated. He cannot be sanctioned under Rule 102(e) for failing to follow a patently inaccurate interpretation of the governing accounting principles.

C. The hearing demonstrated that the Division's charges rest on impermissible hindsight.

Rule 102(e) does not authorize the Division to second-guess an auditor's conduct in the "stark light of hindsight." Amendment to Rule 102(e), 63 Fed. Reg. at 57168. The Rule "focuses . . . on what the accountant knew, or should have known, at the time an action was taken or a decision was made." *Id.* That limitation on Rule 102(e)'s scope is particularly apt here.

At the hearing, the Division on several occasions demonstrated that its case against Mr. Aesoph is the product of hindsight. It put this tactic on display by repeatedly introducing evidence about the causes of TierOne's eventual failure in 2010, long after the year-end 2008 audit was completed. Counsel for Mr. Aesoph objected to this evidence. As counsel explained, "there is no allegation in the OIP that any behavior of Respondents caused the failure of the bank. There is no evidence that any accounting caused the failure of the bank. The bank failed because they made loans in areas where real estate markets crashed." (Tr. 129:23–30:3 (Counsel for Resp't Aesoph).)

The Division relied chiefly on Mr. Pittman, the OTS Field Manager, to introduce evidence about TierOne's collapse. The Division, however, was not interested in hearing Mr. Pittman's perspective *at the time of the year-end 2008 audit*—instead, it focused its questions on whether Mr. Pittman agreed with a report issued by the Department of Treasury Office of Inspector General in 2011. (Tr. 1426:7–27:5 (Pittman).) On cross-examination, however, Mr. Pittman was given the chance to describe his view of the facts as he understood them in early 2009.

Mr. Pittman explained that in early 2009 he believed TierOne management had the ability to right the ship despite the unprecedented economic conditions and despite TierOne's heavy investment in the markets hardest hit by the financial crisis. Like the auditors, he "didn't know what was going to happen with the real estate market," but he believed "TierOne management was working to address the issues that had been identified by OTS" and would weather the storm if it took "the steps necessary to correct the problems." (J.P.F. ¶ 205–06 (Tr. 1455:10–18, 1456:24–57:9, 1456:18–23 (Pittman)).) This is precisely what Mr. Pittman told Mr. Aesoph and Mr. Bennett when they called him as part of their audit procedures to confirm TierOne's compliance with the OTS's regulatory directives. (J.P.F. ¶ 206.) There is no basis for concluding that the auditors should have anticipated, much less prevented, TierOne's failure when the OTS itself believed management was taking the necessary steps.

The Division's selective use of hindsight is all the more troubling because it ignores one of the most significant revelations that occurred shortly before TierOne failed: the fraud

TierOne's management perpetrated on the auditors themselves. (J.P.F. ¶¶ 442–50.) The Division never asked Mr. Pittman a single question about that fraud. That topic was once again reserved for cross-examination. (Tr. 1461:14–62:23 (Pittman).) Thus, in the Division's view, TierOne's failure, viewed through the lens of hindsight, is relevant to auditor's performance. But the fraud—including management's deception as to the very loans at issue in this case—is of no moment. (Tr. 40:24–41:6 (Division's Counsel).) This is fundamentally unfair and contrary to the significance the Commission itself placed on the fraud against the auditors. In its complaints against management, the Commission has alleged that senior Bank personnel engaged in a scheme to make "false representations to" the auditors by "falsifying" FAS 114 documentation and "failing to inform the auditor[s] of appraisals and other valuation information that demonstrated significant declines in the collateral underlying the bank's impaired loans." (J.P.F. ¶¶ 442–43.) Rule 102(e)'s categorical prohibition on the exercise of hindsight was designed for cases just like this one.

D. The Division's charges involve only a portion of a single account, the ALLL, and therefore fail to satisfy the "repeated instances" prong of Rule 102(e).

The Division has alleged that Mr. Aesoph engaged in "repeated instances of unreasonable conduct" under Rule 102(e). That provision of Rule 102(e), however, does not apply to this case.

The administrative issuing release for Rule 102(e) explains that the phrase "repeated instances" requires at least "two separate instances of unreasonable conduct occurring within one audit." Amendment to Rule 102(e), 63 Fed. Reg. at 57169. The release gives, as an example of repeated instances, a failure to "gather evidential matter *for more than two accounts*" or an erroneous certification of GAAP accounting "*in more than two accounts*." *Id.* (emphasis 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.*

The allegations in this proceeding concern only a portion of a single account—TierOne's allowance for loan losses. The Division apparently recognized this weakness in its case, leading it to engraft an unsupportable AU § 561 claim onto the OIP—a claim that the Division appears to have abandoned. *See supra* section II.D. Consequently, the "repeated instances" provision of Rule 102(e) does not apply. This Court has held that a "fair reading" of Rule 102(e) compels this result: "conduct . . . concern[ing] *one account* . . . is . . . *one instance of conduct.*" *Hall*, Initial Decision Rel. No. 341, 2008 WL 140722, *20 (ALJ Jan. 15, 2008) (emphasis added). The Commission, on the Division's appeal from the *Hall* decision, attempted to expand the scope of Rule 102(e)'s "repeated conduct" provision by holding that "[t]here is no requirement that the two instances pertain to different accounts in that audit." *Hall*, Exchange Act Rel. No. 61162, 2009 WL 4809215, at *7 (Dec. 14, 2009).

But even the Commission's order in *Hall*, which was unexamined by the Court of Appeals, does not fit these circumstances. As demonstrated at the hearing, the Division has aggressively narrowed its claims. Having started with an OIP that appeared to challenge the ALLL account, the Division has now determined to criticize only the procedures performed on the FAS 114 portion of the ALLL, has completely ignored the threshold assessment of risk ratings for impaired loans, and has ultimately focused on a handful of 2008 appraisals for properties within TierOne's impaired loan portfolio. The issue posed by the Division now concerns not the ALLL account as a whole but rather a subset of a subset of that account.

Neither the Division's contentions nor its proof comports with the Rule's plain language. The Division's effort to shoehorn its case into the "repeated instances" portion of Rule 102(e) is, instead, yet another example of its effort to amend the Rule by an enforcement proceeding. *See supra* section IV.B. For these several reasons, application of the Rule's "repeated instances" provision to these facts is inappropriate and unfair, and does nothing to advance the Commission's goal of protecting the public.

V.
CONCLUSION

Mr. Aesoph fully complied with all applicable professional standards in planning and performing the year-end 2008 audit of TierOne's financial statements and internal controls. He is not a threat to the Commission's processes. To the contrary, his professionalism as an audit partner—including his conduct in 2009 and 2010, which uncovered evidence of the carefully concealed and collusive fraud at TierOne—demonstrates that Mr. Aesoph is an asset to his profession. The charges against him under Rule 102(e) must be dismissed.

Dated: December 10, 2013

Respectfully submitted,

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

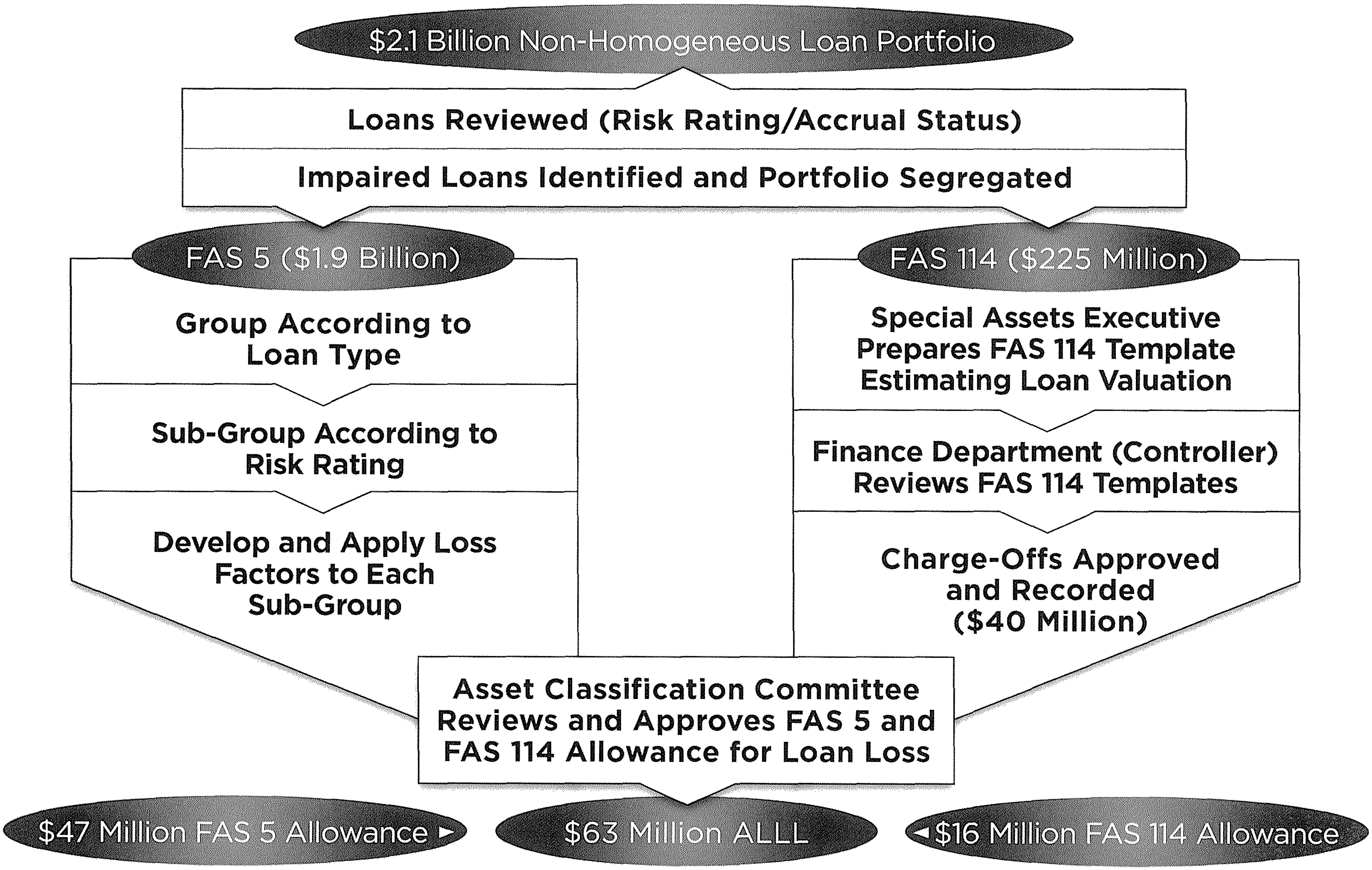
In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit A

ALLL Estimation Process

Respondents' Joint Exhibit
R260
A.P. No. 15168



In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit B

Exhibit E.1 - Loss Recognition on Impaired FAS 114 Loans
(in $1000s)

12/31/2008 Impaired Nevada Loans (a)	12/31/2008 Loan Balance Before Charge-Offs (b)	12/31/2008 FAS 114 Loss Reserves (b)	12/31/07 FAS 114 Loss Reserves (c)	Charge-Offs in 2008 (b)	Total FAS 114 Loss Recognized in 2008
Valley Heights	$ 17,312	$ 6,009	$ -	$ -	$ 6,009
Clearwater Estates	2,426	42	(300)	757	499
Carlos Escapa	23,717	14	-	6,594	6,608
Grand Teton	11,139	271	(420)	2,492	2,343
HDB	19,184	2,827	(2,878)	4,216	4,165
Rising Sun	4,861	216	(480)	1,823	1,559
MME	10,896	267	-	4,056	4,323
Celebrate 50	9,430	418	-	3,975	4,393
Mohave Sun	882	3	-	398	401
Double M	2,143	156	-	103	259
Total Impaired Nevada Loans with collateral deficiencies	**$ 101,990**	**$ 10,223**	**$ (4,078)**	**$ 24,414**	**$ 30,559**
Nevada Loan Loss Recognition in 2008 as % of year-end loan balances before loss recognition					**30%**
12/31/08 Impaired loans in all states (the 45 borrower relationships)	$ 201,947	$ 13,582	$ (8,141)	$ 39,103	$ 44,544
Total Impaired Loan Loss Recognition in 2008 as % of year-end loan balances before loss recognition					**22%**

(a) Excludes loans with no collateral deficiency and therefore no measured FAS 114 loss: Structured Homes, Stratton Group and Pueblo Partners.

(b) Data per Exhibit A to this Report.

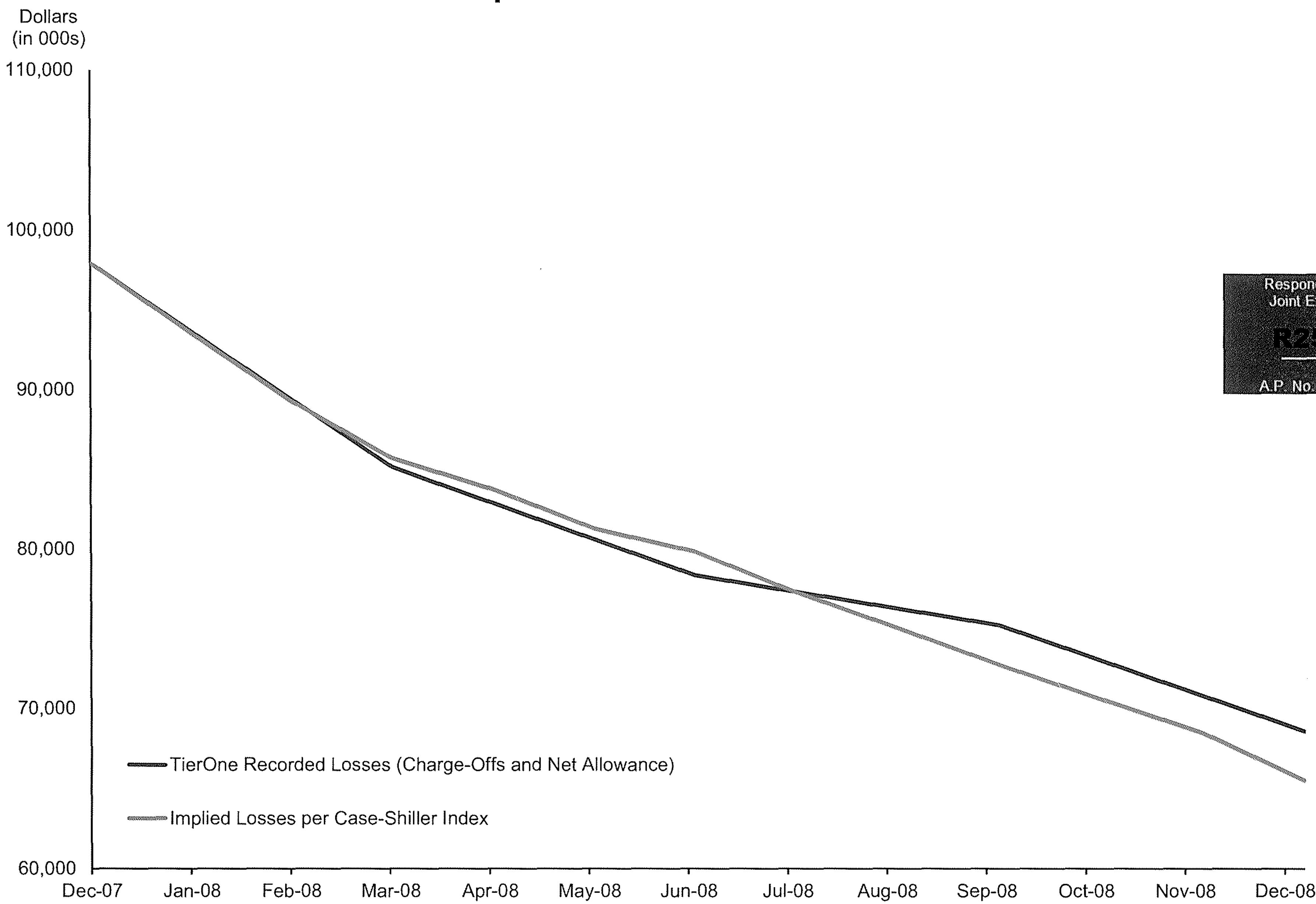
(c) KPMG 2007 Working Paper L32.1, KPMGTO0045667. The 12/31/2007 FAS 114 Loss Reserves in all states includes the $4,078 for Nevada plus Charleston Heights, Gateway Homes, Streamline Construction, Landmark and McDevitt Homes.

In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit C

Losses Recorded by TierOne on Nevada Impaired Loans Compared to Case-Shiller Index



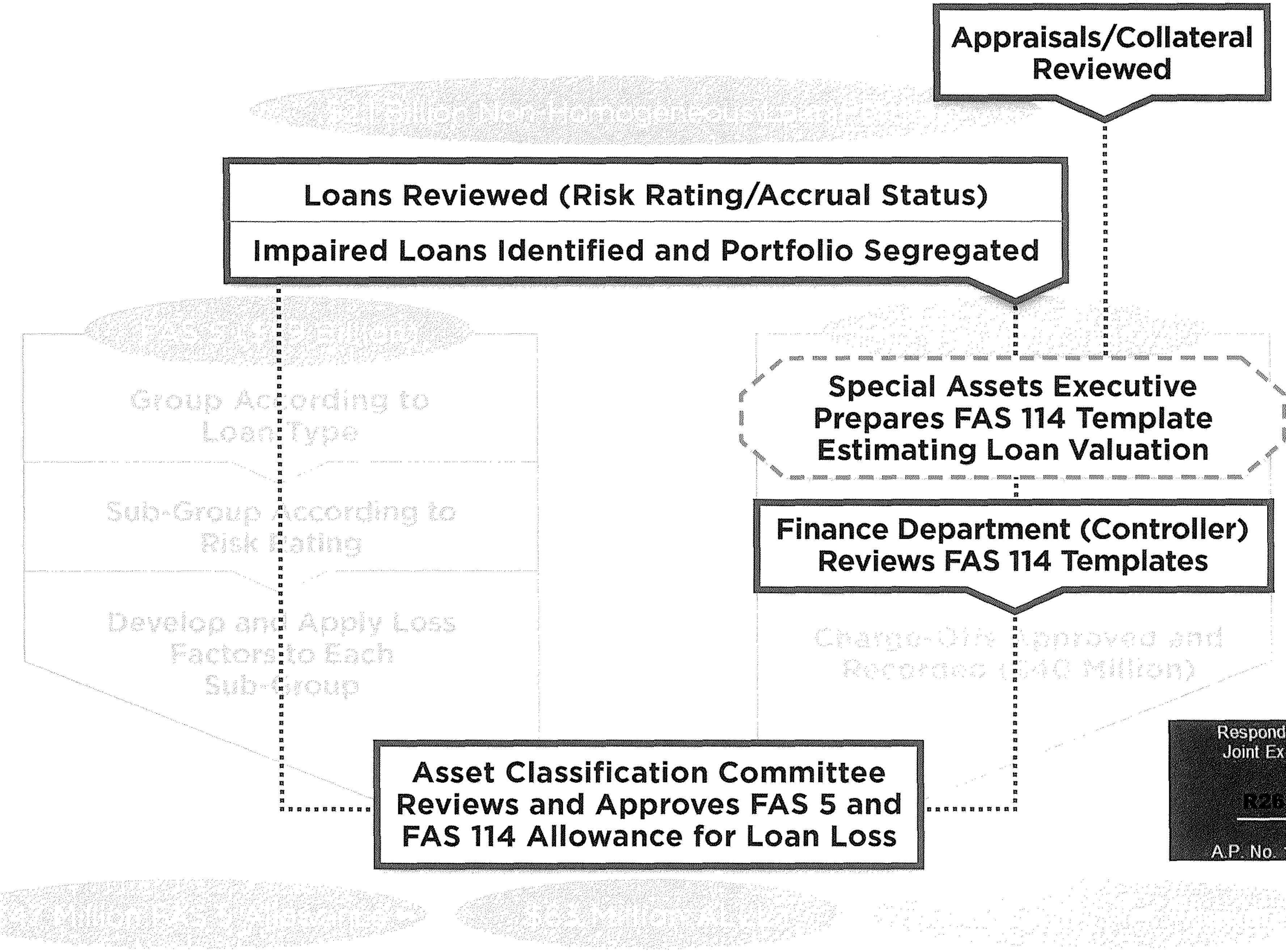
Respondents' Joint Exhibit
R259
A.P. No. 15168

In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit D

FAS 114 Key Controls



Respondents' Joint Exhibit

R261

A.P. No. 15168

DEM-028

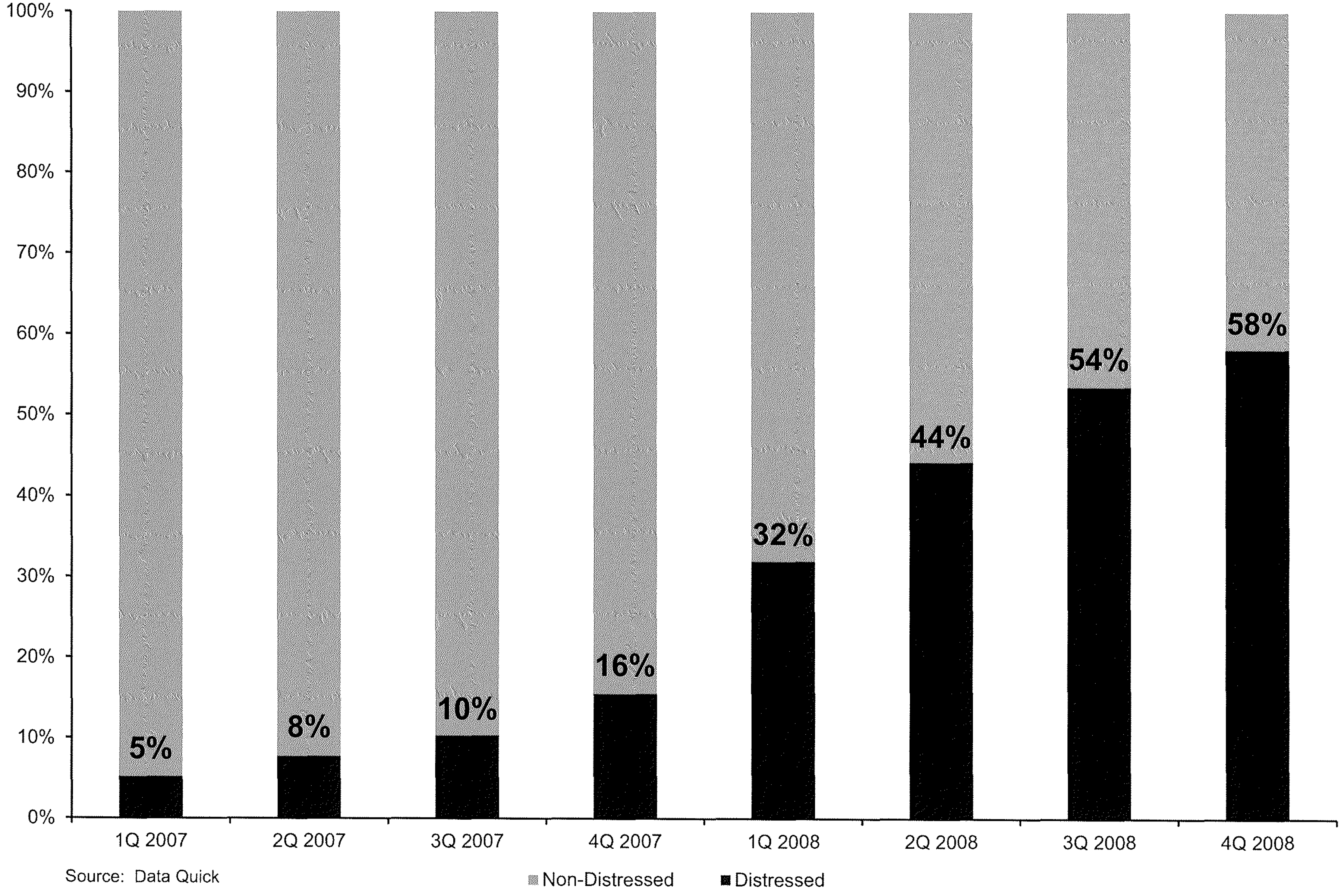
In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit E

Exhibit 5

Percent of Distressed and Non-Distressed Single Family Home Sales
Las Vegas, NV



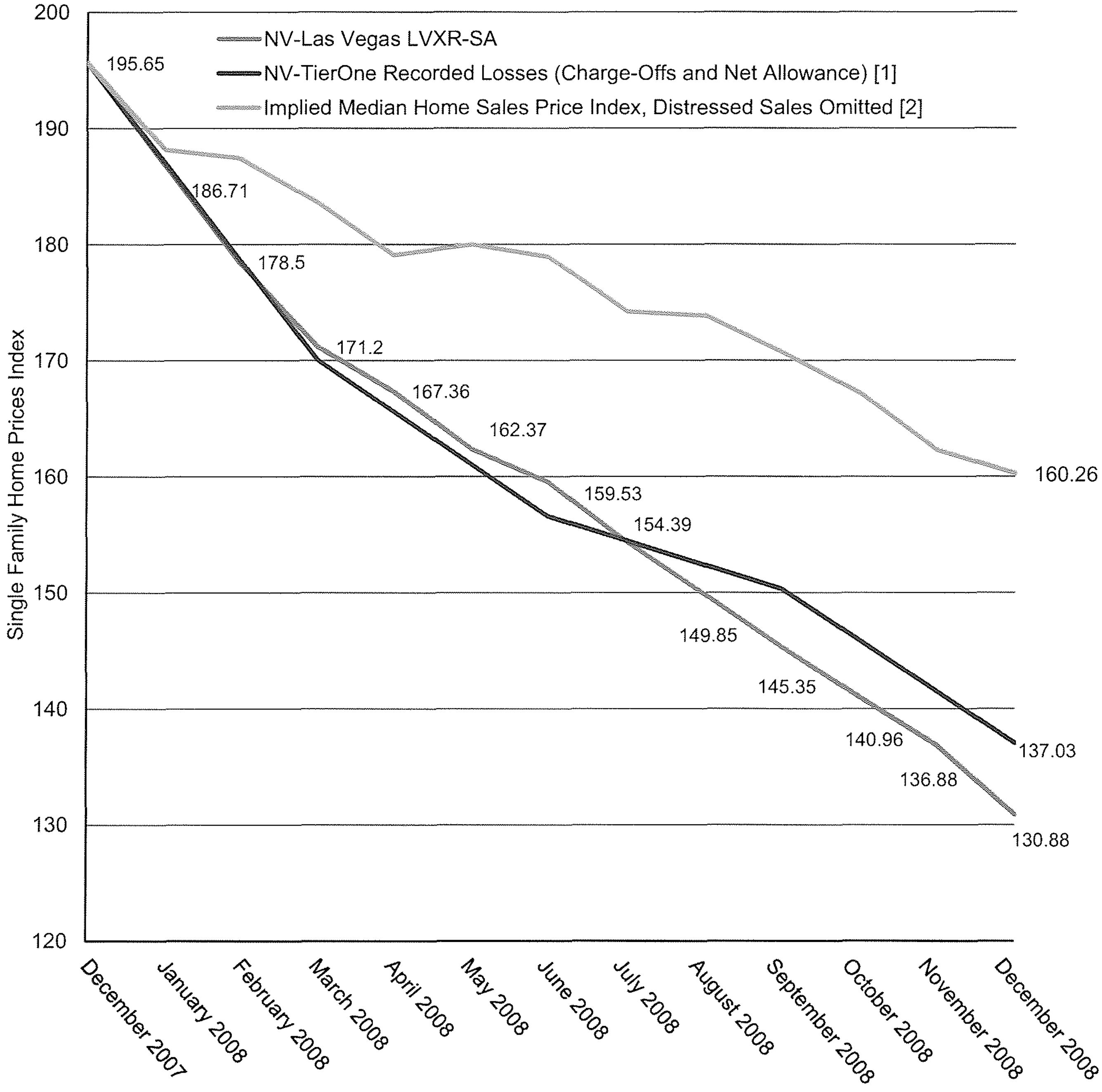
Source: Data Quick

In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA
Administrative Proceeding
File No. 3-15168

Respondent John J. Aesoph's Post-Hearing Brief

Exhibit F

Percentage Losses Recorded by TierOne on Nevada Impaired Loans Compared to Home Price Index With Distressed Sales Omitted



Source: Case-Shiller Index; Data Quick; KPMG workpapers (KPMGTO0000402, KMPGTO0000409, KMPGTO0000905, KMPGTO0001812, KPMGTO0005590, KPMGTO0005374, KPMGTO0005485, KPMGTO0005487, KPMGTO0005527, KPMGTO0005488, KPMGTO0005496, KPMGTO0005499, KPMGTO0005504, KPMGTO0005511, KPMGTO0005519, KPMGTO0045655)

Note: Each Bates number reference is for the first page of analysis in the working papers.

[1] Losses are the sum of provisions and charge offs. The TierOne Losses are pegged to the Las Vegas, Nevada, Case-Shiller Index (as shown in the Barron Report) as of December 2007. Loans in analysis include: Carlos Escapa, Celebrate 50, Clearwater Estates, Double M Construction, Grand Teton Residential, HBD LLC, MME LLC, Mohave Sun, Rising Sun and Valley Heights.

[2] Implied index was calculated by applying the monthly percentage change in the median home sales price of non-distressed sales from Data Quick to the Las Vegas, Nevada, Case-Shiller Index (as shown in Barron Report) as of December, 2007.

Respondents' Joint Exhibit
R258
A.P. No. 15168