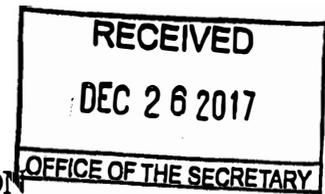


**BEFORE THE
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.**



Admin. Proc. File No. 3-17758

In the Matter of the Application of
CYNTHIA C. REINHART, CPA
For Review of Disciplinary Action Taken By the
PUBLIC COMPANY ACCOUNTING
OVERSIGHT BOARD

HARD COPY

**PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S
SUR-REPLY IN RESPONSE TO COMMISSION'S NOVEMBER 16, 2017 ORDER**

December 22, 2017

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The PCAOB appreciates the opportunity to respond to the Commission’s order. The Board, including both accountant members, unanimously found Reinhart violated PCAOB rules and auditing standards in the 2007 Thornburg audit and her conduct was no less than negligent. The concurring-and-dissenting member noted that Reinhart “negligent[ly]” “failed in her duty to gather sufficient evidence, and evaluate that evidence, to support the audit opinion, particularly in light of contrary evidence available to her” and that she “should have taken more time to evaluate the evidence, understand the implications and address the consequences of the situation, before the audit report was issued.” Yet to Reinhart this is all “nonsense,” “absurd,” “preposterous,” “outlandish”; “distort[ing] and mischaracteriz[ing] the evidence”; not how “any reasonable regulatory authority” acts in its “proper role.” Reply 2, 4, 11, 13, 21. Having tried in her opening brief to shift the focus from her audit work with broadside, insubstantial arguments about notice, judgment, hindsight, and a now-dismissed action (Opp. 3, 21-22, 35-40), she now claims to make her best effort to “set the record straight” about her work (Reply 2). Though purporting to invite scrutiny, however, she immediately resorts to blanket caricature and dismissal of 100 pages of detailed Board fact-finding and analysis, firmly rooted in the record, as “reliance on hindsight” and “[d]evising alternative audit procedures after the fact.” Reply 1-4, 10-11, 20. The question all this naturally raises is, why is such distraction and rhetorical excess necessary if the substance of her work holds up to scrutiny. The plain answer: it doesn’t.

I. Reinhart’s Badly Deficient Audit Work Was Far From a “Reasonable Approach.”

A. Going Concern

Reinhart’s “uncritical, often cursory, and overall deficient evaluation of, and reaction to, circumstances” in the going-concern area violated PCAOB standards. Opp. 22-26. Merely “document[ing]” certain “events in the Subsequent Period” (Reply 10) did not “evaluate”

whether there was substantial doubt about Thornburg's ability to continue as a going concern for a reasonable period of time based on "knowledge of relevant conditions and events" obtained from "application of auditing procedures." AU 341.01-.03a, .05 (procedures for identifying "conditions and events"). Nor does it satisfy fundamental auditing principles. Opp. 17-19. She failed to properly consider aspects she herself recognized as important in this high-risk area.

1. Liquidity

Reinhart, in denying one flaw in her liquidity analysis, draws on and reasserts other flaws. First, she tries to dismiss the "admitted error" (Reply 12), in the audit memo that represented her going-concern analysis (J-19 at 5-6) and in the audit completion document (J-5 at 9, 19), that Thornburg's "over collateralized" position on its short-term debt gave it "additional protection" or a "cushion" of 7% "against margin calls for changes in fair value of the securities." In fact, the 7% represented the margin amount Thornburg already had to maintain.

The auditors themselves affirmatively developed the point about the 7% "cushion," calculating it to be \$900 million; Thornburg's corresponding memo mentioned no such thing, only noting "protection against additional margin calls for up to [a] 4.5% decrease in the market price of the assets," representing cash and unpledged securities at year-end 2007. J-21 at 5; J-19 at 5; FD 34. The 11.5% figure is the only quantification in KPMG's memo of the "decline in the value of available cash and securities" that Thornburg could absorb before it "could not satisfy margin calls," against which other information was considered. J-19 at 5-6. The memo's "Base Scenario" paragraph addressed Thornburg's then "current economic and financial position" (Tr. 228, 614), but nothing in the paragraph "updated" (Reply 13) the 11.5% figure for the Subsequent Period. The statement there that Thornburg "maintains the 7% cushion" (*see id.*) merely perpetuated the 7% error, made earlier in the memo, while the paragraph did not adjust

the year-end 4.5% figure, despite its importance as protection going forward and the indication management expected further margin calls. J-19 at 5-6; FD 36.

At the hearing, Reinhart conceded the error. Tr. 230-31, 236. She had reviewed multiple versions of the memo containing the error and even commented directly, “how’d we pick this number?” FD 35. Asked if “it wasn’t until the restatement period that you determined that the seven percent...was not available to meet margin calls,” she answered, “That’s correct.” Tr. 231. Similarly, her high-level reviewers testified they wanted to know the protection Thornburg had against future margin calls and took it to include the 7% cushion stated in the memo. *E.g.*, Tr. 1782-84, 1991-94. Reinhart offered no explanation or defense of the error in response to allegations and arguments about its seriousness. *See* RD 1 at 16; RD 95 at 28-29; RD 101 at 8; RD 119 at 30-31; RD 126 at 11. Her SEC petition did not mention it, and her brief skimmed over it as “not critical to [her] decision” in light of “more compelling factors.” Br. 28.

Now Reinhart claims it was a “drafting error” she did not “believe[]” of “zero impact.” Reply 12-13. She patches together unconnected testimony conceding the 7% error (Tr. 236) with general testimony about the mechanics of the margin requirement (Tr. 604-05, 974). She also cites a general reference in the “Base Scenario” paragraph to “collateral in excess of debt of 7%,” but the very next sentence repeats the 7% error. And she contends the error, representing an extra \$900 million cushion from pledged securities, conflicted with the memo’s earlier statement that “[t]he cash balance”—not her paraphrase, “the Company’s liquidity position” (Reply 13)—“around February 22, 2008 is relatively tight, at ~\$45.5 million” (J-19 at 5). The 7% came from a different source than “cash and unpledged securities,” the 4.5% protection. *Id.*

Second, Reinhart cites the \$45.5 million figure as showing she was “carefully monitoring and discussing” Thornburg’s liquidity (Reply 11, 13), but if that was the liquidity, it equaled a

mere 0.35% cushion. There was no analysis of how Thornburg could meet margin calls with so little protection, let alone calls associated with a further 2-3% drop in values. FD 36-37. Worse, the figure included \$35 million supposedly from a minimum balance in a BlackRock account, but there was no audit evidence that amount existed or was readily accessible (FD 20 n.11).

Third, Reinhart only digs the hole deeper by suggesting (Reply 13) the \$45.5 million cash balance was “updated” in the audit completion document to \$150 million. If that figure were an “update,” it would have been \$27 million, per that day’s corresponding cash report. FD 59.^{1/}

The \$150 million figure, a management representation for readily available liquidity on February 27, 2008, was not mentioned in KPMG’s memo or the audit completion document’s going-concern summary. J-5 at 19-20; J-19. It only appears in a later section of the completion document, divorced from the earlier discussion. That later section concerned disclosure, which Reinhart says she walled off from her consideration of going concern when it came to margin-

^{1/} About the cash reports, contrary to Reply 10, Reinhart’s prior briefing stated, “While this was a new tool for the Company, the engagement team considered them useful because they were prepared by [Thornburg] personnel... whom the team knew to be competent and knowledgeable.” RD 96 at 67. Previously, she deemed the reports the “best estimate” of Thornburg’s available cash as of the report dates. Tr. 204-05. The going-concern memo stated (J-19 at 7) that through February 22, management’s next-day projections had been reliable “within 5%.” And she identified a cash report as a “red flag” calling for monitoring. FD 24. Had she “reviewed” and “discussed” (Reply 10) the reports as she should have in the final days of February she would have realized Thornburg’s cash balances remained low, well below its projections. FD 25, 65. The cause was its high margin-call activity, as to which her work was also inadequate. FD 61-62. An expert did not “conced[e]” it was “impossible” (Reply 11) to do audit work on Thornburg’s February 27 cash balance; he said given the importance and late date he would have at least “gone and looked at [Thornburg’s] actual primary books and records” (Tr. 1458). The auditors were then at Thornburg daily in office space a floor below its management and capital markets/accounting groups. FD 5. Despite the vague, general testimony Reinhart cites (Tr. 910-11), there is no indication she considered the reports’ low balances in the days before the audit report issued. If she had, she has no answer for why in a high-risk environment she had no concern about them when by then Thornburg was relying solely on cash for its readily available liquidity, and why she did not press management to reconcile the balances, including the \$27 million, with its \$150 million representation.

call data received around the same time as the \$150 million representation. Br. 36; Reply 14; Opp. 29-31. She did not test that figure, and she lacked clarity on Thornburg's readily available liquidity, which she never ascertained in the Subsequent Period. FD 20-21, 58 n.26; RD 121 at 23; Tr. 184-85. Mere documentation of the figure elsewhere (Reply 10), in the context of striking it from draft disclosure, in no way shows she evaluated it with due care.

All Reinhart can cite (Reply 12) for an audit procedure performed on the representation is a rough estimate the senior manager claimed to make (\$129 million), which did not add up to \$150 million and included an unreliable "projected" \$94 million and the baseless \$35 million BlackRock amount. FD 20 n.11. The \$31.6 million Thornburg mustered the next day, faced with \$157.5 million in margin calls, underscores the shoddiness of the estimate. *Id.*

2. Securities values

Thornburg's August 2007 defaults demonstrated the strong correlation between a drop in securities values and receipt of margin calls. From then through end of February 2008, its securities values overall dropped 20%, 5-10% in the Subsequent Period, and 10-15% in the last two weeks in the Alt-A subset of its securities—all resulting in margin calls. FD 15.

By February's final week, management informed Reinhart and the senior manager of its projection for future declines. Tr. 928-30. Management stated that a further 2-3% drop was possible, contemporaneously documented by the senior manager as "2-3% drop = maybe," but that a larger drop was remote. *Id.*; FD 37. KPMG's going-concern memo reflected only the latter. J-19 at 6. But as the senior manager testified, it was not management's view that Thornburg's asset values were not going to decline, but that they would not likely decline more than 2-3%, that is, that there might be a 2-3% drop "over the foreseeable future." Tr. 929-30.

This was consistent with the auditors' view that J-19's Base Scenario was Thornburg's then "current economic and financial position," *i.e.*, the "probable" scenario. Tr. 614, 1077.

Reinhart intimated the decrease was projected to occur over a "very short period of time...into the March time period." Tr. 237. Similarly, her Board brief assumed a near-term timeline, describing it as an "expected" 2-3% decrease. RD 118 at 25. In the audit, she viewed the 2-3% news as a sign of relief, given the tumultuous past two months, regarding it as "significant" and a "key assumption," on which she relied, that the markets were stabilizing, "at or approaching bottom." Tr. 243-45, 617, 940, 1095; J-19 at 6; FD 18; *see* Br. 11 ("bottoming out"). That testimony and her opening brief's description of the information as a "datapoint to consider" on which she supposedly "did obtain other audit evidence" refutes her claim elsewhere it was merely a "prediction of future events" that "was not susceptible to audit work." Br. 34-35; Reply 7. Indeed, AU 341.02 contemplates a prospective evaluation. Opp. 27.

Reinhart did nothing to assess whether Thornburg could meet the margin calls associated with a 2-3% decline (\$250-\$375 million), despite delaying her going-concern evaluation to "have the greatest amount of information available regarding the state of the market for MBS securities and Thornburg's liquidity." Tr. 137-38, 240-41. She did not examine whether Thornburg could meet margin calls associated with even a 1% further decline. FD 37. She also obtained no evidence, beyond company assertions, about the reasonableness of the percentages, nor did she reconcile management's view that the market was stabilizing with contrary evidence in Thornburg's Form 10-K. FD 38. She conceded she did not consult with any market or valuation experts. Tr. 251-255, 797. And internal guidance from February 2008 warned that "[t]he volatility in the credit markets" was "expected to extend well into 2008." Ex. R-50 at 51.

Reinhart initially claimed Thornburg simply said “the likelihood that collateral values decrease *by more than another 2 to 3%* is remote” and “never addressed the probability of a potential 2 to 3% decline.” Br. 33. The notion that Thornburg offered a disconnected statement about a drop of more than 2-3% being remote with no statements or implications whatsoever about 2-3% or less is artificial, far-fetched, and at odds with the senior manager’s testimony and notes. Yet, despite the August 2007 defaults, Reinhart admittedly did not even try to understand whether Thornburg could meet margin calls associated with even a 1-2% decline, which, with other errors, rendered her analysis “deeply flawed.” FD 60.

Reinhart now cites her stray hearing assertion that management told her “a further decline in a very short period of time by another two to three to percent” would be “*unlikely*.” Reply 5. But she attributed that to the same sentence in J-19 at 6 (Tr. 238) that, on its face and as her testimony and initial position otherwise consistently refer to it, simply stated that the likelihood of a further decline in collateral values exceeding 2-3% was remote. Tr. 614-15, 635, 795-96. Nothing corroborates her refashioned claim (Reply 5) that management’s expectation was long-term. The senior manager’s testimony did not suggest a decline “but only” over a longer timeline (Reply 6); it simply acknowledged the 2-3% drop: “Right...over the foreseeable future.” Tr. 929-30. No one suggests (Reply 6) “management was forecasting a 2-3% drop the very next day.” A drop of 2-3% or less need not be likely to be less than remote, or reasonably possible.

The point, which Reinhart cannot obscure, is she did nothing with this information as it related to Thornburg’s remaining liquidity. FD 37. She claims she “document[ed]” a variety of sources of liquidity (Reply 6), but her own testimony and memo made clear she did not rely on “upcoming” capital raisings. Opp. 24; FD 33, 80; Tr. 126. Despite the February principal and interest payment, liquidity remained critically low. FD 65-66.

Reinhart claims she could not consult within KPMG about “the future direction of securities prices.” Reply 7. She testified she made no effort to reach out beyond Thornburg and the audit team on the 2-3% information. Tr. 797. Yet KPMG’s Department of Professional Practice had recently issued a Professional Practice Letter (PPL), discussing the continuing volatility in the credit markets. R-50 at 51. Contacting that group with questions was encouraged by the PPLs generally and something Reinhart did on other matters. See J-57 at 2; J-64 at 9; Tr. 496. Although Reinhart now highlights the in-depth reviewer, who was not an audit team member (J-9 at 9), there is no evidence that what he might have “learned” (Reply 7) from another client was shared with Reinhart or that it had value. *S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 WL 3339647, *4 (July 13, 2013); Opp. 22 n.3.

Reinhart never reconciled management’s grounds for saying the market was stabilizing (reflecting 2-3% view) with Thornburg’s contradicting 10-K disclosures: “valuations remain volatile,” “deterioration in the liquidity for [its] securities,” “increased difficulty in obtaining market prices.” FD 37-38. AU 333.04 required it; AU 230.07 required professional skepticism.

The foregoing discussion also illuminates the inadequacy of the so-called “stress testing” in Scenarios 1 and 2 of KPMG’s going-concern memo (Reply 8-9). They made no mention of specific percentage changes or the available liquidity, were based on “year end” figures without consideration of the later declines in market conditions, and relied on multiple levels of conjecture. Opp. 29; J-19 at 6 (speculating that operations “would continue” to be profitable, Thornburg “could continue” to earn a margin, it would be able to “securitize the loans into additional collateralized debt obligations,” and yields on the remaining CMD securities “would be more than sufficient”). They assumed factors Reinhart conceded are specified by AU 341.01 as “significantly contradict[ing] the...assumption” of continuation as a going concern. Tr. 87-

90, 402-04. Likewise, AU 341.06 identifies the “need to seek new sources or methods of financing or to dispose of substantial assets” as examples of conditions and events that indicate “there could be substantial doubt” about the entity’s ability to continue as a going concern. Citing her expert, she claims the scenarios were “critically important” and “foundation[al],” yet she only hastily included them at someone else’s initiative and the expert did not mention them in his report. *Compare* R-160 with D-128 at 90-95; Tr. 1265-67, 1272-73, 1282-83.

3. Margin calls

It was unreasonable for Reinhart to rely exclusively on uncorroborated management representations about margin calls in an area identified as high risk and prone to management misrepresentation and to ignore critical margin-call data that was provided in late February 2008.

After learning of Thornburg’s low cash balance on February 20, and with August 2007 in recent memory, Reinhart directed the senior manager to request a margin-call list from Thornburg to “understand the company’s ability to meet margin calls and what they had received in [the Subsequent Period]” (Tr. 299) because of “the need to conclude about [the] ability to meet margin calls in Jan + Feb (to date) and future expectations” (J-116 at 4). FD 18, 26-27, 59; Opp. 13; Tr. 302. The margin-call data was “critical to both the going-concern and ability-to-hold evaluations” and had potentially “wide-ranging effects” on the audit. Br. 20, 39, 40, 42.

Yet, simply because management stated it could not provide the information in the “form” requested, Reinhart abandoned any effort to obtain any such data (Tr. 304; FD 27), based purely on the conclusory, non-specific excuses recited by her and senior manager (Reply 14). When Thornburg provided certain margin-call schedules on February 27, Reinhart ignored the inconsistency of it now being able to provide margin-call data when it earlier had provided none, the last-minute timing, the heightened risk involved, and the data itself. It makes no difference

whether the data was provided “in response to” the earlier request or for a “limited purpose” or to a “junior” auditor (Reply 14-15; Br. 36). What matters is the vitally important content and that Reinhart knew it had been received but did nothing. FD 28-29 & n.13; Opp. 13. Even the in-depth reviewer believed Reinhart should have at least “read” the schedules. FD 27.

The schedules are clear on their face. Three identified the date, amount, and counterparty of the margin calls (J-1 at 40-42), while two (J-1 at 40-41) showed the amount and date(s) Thornburg paid on the calls. One showed calls being paid (“pd”) untimely over multiple days. J-1 at 41 (noting payments for Citigroup’s “2/21 call” on “2/22/2008,” “2/25/2008,” and “2/26/2008” and Greenwich’s “2/21 call” on “2/25/2008”). J-1 at 40 identified an “asset sale” and “sale of asset” along with certain margin calls received. Reinhart conceded it was “reasonable” to conclude Thornburg may have been selling assets to meet margin calls and said if she had noticed such references she would have requested more information. FD 28 n.13. She conceded that J-1 at 40 showed Thornburg was paying off a \$196.5 million margin call over several days and said she had no recollection of Thornburg ever taking several days to pay a call. Tr. 323. She now claims she could only “explain” a schedule “based on information learned in the restatement period” (Reply 15), but all she cites is testimony acknowledging not reading it until then and saying its meaning is “a reasonable conclusion” from its plain language (Tr. 321-22). Her citation of certain hearing testimony about limited aspects of J-1 at 40 (Reply 15) ignores investigative testimony (Tr. 319-20) that she knew exactly what even that information meant. The cited expert testimony (Reply 15) suggests no confusion at all. *See* Tr. 2105 (schedule shows Thornburg untimely paying margin call). Reinhart’s notion that the schedules could simply have been dismissed, without any audit inquiry or follow-up, is insupportable.

Having ignored that information, Reinhart tries to dress up her overreliance on management representations (Reply 16, 19). She unquestioningly accepted the assertion that margin calls in the last two weeks of February 2008 were “unusual.” Her claim about a mid-February 2008 event (Reply 15) misses the point that, as she conceded, she lacked any baseline from which to judge the assertion. FD 26. Had she paid any attention to the margin call schedules, she would have learned of high margin calls received in the first two weeks—before the mid-month event—not just the last two weeks of February. FD 29.

Reinhart also argues she could have inferred the amount of margin calls from the “corresponding...decline in the market value of the assets pledged as collateral.” Reply 16. “Untested speculation and guesswork,” however, is no substitute for proper audit work. *Hatfield*, 2013 WL 3339647, *15, *23. She admittedly never made such a calculation and did not discover until the restatement period that Thornburg received nearly \$1 billion in margin calls in the Subsequent Period, testifying she was “surprised” and that, had she known, it might have caused her to change her audit conclusions, a view shared by her reviewers. FD 30-31.

Reinhart’s claim she “understood that those margin calls had been met in accordance with the agreements” (Reply 16) ignores her admission that the auditors never reviewed the “daily cash settlements with rev repo lenders,” the sole evidence cited in the work papers for management’s assertion that “Thornburg has met all margin calls.” FD 27, 39 & n.19. She cites only her speculation on that subject (Tr. 331) and the in-depth reviewer’s false assumption it had “been looked at by the engagement team” (Tr. 1720). The auditors cited neither the absence of liquidations nor continuation of financing as supporting management’s assertion. Reinhart admitted that such evidence was only good through February 20, 2008. There is no evidence lenders knew of Thornburg’s liquidity problems until its 2007 10-K.

B. OTTI/Ability-To-Hold

Reinhart's evaluation of Thornburg's ability to hold its impaired securities was "seriously flawed" (FD 75). She failed to consider "relevant information" and to "obtain evidence" that "tend[ed] to corroborate or conflict with management's conclusion" AU 332.48, .57(f) (identifying whether "the entity's financial position...provide[s] evidence of its ability to hold"). She violated AU 332 and fundamental auditing principles. FD 77-83.

Reinhart did next-to-nothing in the audit particular to this issue, despite Thornburg's recent experience in August 2007, when it "lost the ability" to hold its securities even though management had no "intent to sell" (FD 11). KPMG's going-concern memo, supposedly representing her OTTI/ability-to-hold analysis (Tr. 132-33; D-47 at 8; R-34 at 1), said nothing about ability to hold. FD 40-41. In testimony, Reinhart attempted to divine an OTTI/ability-to-hold evaluation from the going-concern memo and from essentially a cross-reference to that memo in the audit completion document. *Id.* Her lack of substantial effort and independent analysis in the OTTI/ability-to-hold area and the Board's assessment of her audit work in that light in no way validate (Reply 16) her so-called "approach."

A complete overlap of the separate, distinct evaluations of going concern and OTTI/ability-to-hold was not a reasonable approach. Reinhart understood that management needed to affirmatively demonstrate Thornburg was able to hold its impaired securities until recovery and that under FAS 115 there was no presumption to that effect. Because management based its conclusion on Thornburg's "liquidity position, and ability to continue to make margin calls" (J-21 at 10), she knew she had to evaluate those grounds. AU 332.48 and .57 required it, and in so doing she had to employ fundamental audit disciplines. By contrast, the going-concern issue required consideration of whether "conditions and events" identified by "application of

auditing procedures” contradicted the going-concern assumption. AU 341.01-.03a. As the Board unanimously found, this distinction was starkly illustrated by the divergent stress-testing scenarios and the August 2007 events where Thornburg lost the ability to hold its impaired securities almost immediately but could keep operating. Reinhart not only defaulted to the going-concern evaluation for her OTTI/ability-to-hold evaluation, conflating the two, but her audit work was so badly flawed it served neither purpose.

Reinhart weakly suggests her OTTI/ability-to-hold evaluation had some particular, meaningful substantive content, while also trying to obscure it could diverge from the going-concern evaluation. First, she asserts that the ten points she cobbles together in briefing as a separate OTTI/ability-to-hold evaluation “correspond exactly” with “the types of evidence listed in” AU 332.47 and 332.57(f). AU 332.47 lists examples of factors that bear generally on “[d]eterminations of whether losses are other than temporary,” not specifically on ability to hold, and three of four examples in AU 332.57(f) indicate a lack of ability to hold. As to the Board’s detailed analysis (FD 80-83), she quibbles about 4, 7, 9. Reply 17-18. (Points 1-3, 6 relate to intent, not current ability to hold; nor do 5, 8, which speak to the securities themselves; 10, that only appreciated securities had been sold, is not evidence about ability to hold impaired ones.)

To the extent points 4, 7, 9 have any grounding in audit documentation they refer to conclusory representations that management had “no plans or intentions that may materially affect the carrying value or classification of assets and liabilities” (J-4 at 3) and “ha[s] both the intent and ability to hold these impaired securities” (J-4 at 6; J-1 at 104). FD 81-82. Reinhart and others had concerns about the efficacy of management’s plan to manage liquidity (J-21), which failed to address significant Subsequent-Period circumstances. FD 18-19. As to points 7, 9, simply obtaining “management’s plan” was no substitute for evaluating, under AU 332.48,

“whether management considered relevant information” and “obtain[ing] evidence” that “tend[s] to corroborate or conflict with management’s conclusions,” which she failed to do. Nor was the plan working: liquidity continued to fall. FD 15, 21-22. Point 4 is contradicted by work papers and testimony (consistent with internal guidance) stressing she did not rely on future capital raising and securitizations, as they were too speculative. FD 80; J-64 at 8; J-19 at 4.

Second, Reinhart denies the going-concern memo’s stress-testing Scenarios 1 and 2, which assumed asset sales, are part of her evaluation—represented by the same memo—of Thornburg’s ability to hold its impaired securities. Nothing in the work papers suggests such exclusion. FD 45. Those scenarios, together with the forced sales in that audit year, provided information that Thornburg, under certain circumstances, might be forced to sell securities, and Reinhart had to take this contrary evidence into account in her OTTI analysis. AU 326.25. In cited testimony (Reply 17), she stated those scenarios were “relevant to the circumstances at hand” and bore on liquidity (Tr. 228), and the in-depth reviewer only said the scenarios are not “as” relevant to OTTI (Tr. 1709). But Reinhart insists they “applied only to the going-concern analysis,” based on: (1) her say-so (Tr. 228, 258); (2) the suggestion that just because the stress testing was requested by a partner only consulted on going concern, the substance it provided could have no other significance (Tr. 614, 1148); (3) the senior manager’s conclusory assertion, at odds with the in-depth reviewer (Tr. 1145); and (4) discredited expert testimony. Reply 17.

Although Reinhart’s expert’s report did not mention the scenarios (R-160), Reinhart cites his off-the-cuff testimony that they “would be inappropriate” for OTTI consideration, which is restricted to the “present condition of the company,” not future conditions (Tr. 2173, 2332). That testimony reflected the expert’s extreme, unfounded approach that there was no evidence

Reinhart followed, that was supported by neither the GAAP standard the expert cited nor AU 332, and that was contradicted by AU 332.47 and by part of his report. FD 77-79; Opp. 20, 33.^{2/}

II. Reinhart's Audit Misconduct In The Going-Concern Area And The OTTI/Ability-To-Hold Area Each Constitutes At Least One Separate Instance Of Negligence.

The Sarbanes-Oxley Act uses “repeated instances of negligent conduct, each resulting in a violation...” (and separately “intentional or knowing conduct, including reckless conduct, that results in violation...”) to describe a level of conduct to which specified, more severe sanctions can apply. 15 U.S.C. 7215(c)(5) (cross-referencing 7215(c)(4)). The other sanctions listed in 7215(c)(4) are not limited in application to that level of conduct (FD 88 n.36, 91 n.37), which is why Reinhart’s baseless refrain (Br. 3, 43; Reply 22-23) that no sanctions may be imposed unless her conduct rises to that level only shows she misunderstands the statute. For the “repeated instances” language to serve its purpose, it must meaningfully distinguish more serious from less serious auditor conduct, which means it must capture details that inform an understanding of what was done and not done and the reasons it was violative. *See* 15 U.S.C. 7215(c)(4) (Board must find respondent “has engaged in any act or practice, or omitted to act, in violation...” to impose sanctions). Commission guidance and the Board’s analysis applying it recognize this; Reinhart’s few pages of cursory remarks do not.

^{2/} By “simply referr[ing]” (Reply 18) throughout her arguments to a paragraph of AU 560 that is inapposite to the issues here (FD 71-73; Opp. 25-26), Reinhart is claiming she could rely exclusively on management inquiries. The KPMG reviewers cited were not “members” of the “audit team” (Reply 20); conducted only a high-level review, admittedly reading only a handful of documents; and were not made aware of critical information when they were assessing her work. FD 69-70; Opp. 22 n.3. It was Reinhart who was “directly and intimately involved” in the work, knew of “multiple warning signs,” and had “final responsibility” for the audit. FD 3-4, 69-71. Reinhart responds to the reasons the Thornburg emails were excluded (FD 85-88; Opp. 38-40) only with bald assertions and rhetoric—“obviously highly probative,” “**relevant**,” “dead wrong,” “irrational,” “preposterous,” “patently unfair” (Reply 21-22; Br. 21, 40, 42). She never explains why the Board must admit them to analyze her audit conduct.

The only support Reinhart cites in arguing that all her failings in the audit reduce to a single instance of negligence is the initial decision (ID) and the partial dissent (PD). Her “two closely-related issues” characterization (Reply 23) derives from the ID’s use of that language. Br. 43; RD 118 at 36. But the hearing officer, like the Board, correctly concluded that, had Reinhart “considered all relevant up-to-date information in both her going-concern and OTTI evaluations, she might have reached different conclusions regarding the significance of the events that occurred during the Subsequent Period for each issue.” FD 54. The PD’s view that her failure to adequately consider whether Thornburg had sufficient readily available liquidity “gave rise to” her failures to adequately evaluate going concern and OTTI is mistaken and overbroad, for it glosses over its concurrence with the Board’s finding that Reinhart “did not properly differentiate between the two areas.” Opp. 43. She quotes the PD that “the record does not support” a finding of “discernably different conduct in the context of each auditing area” and complains that the Board criticizes the same body of audit work in both areas. Reply 22. But she cannot limit the measure of the seriousness of her conduct for sanctions purposes based on whether she did the same audit work in both areas so badly that it failed them both, disregarding what she should have done and the effects. Just because an auditor may encounter facts with implications for more than one audit area does not transform those areas into one. FD 76-77.

There is no OTTI/ability-to-hold evaluation in the work papers, only a going-concern evaluation that Reinhart cites as serving both purposes. But as the August 2007 events and stress testing illustrate (*id.*), a going-concern analysis does not dictate the outcome of an OTTI/ability-to-hold analysis. Nor is the opposite true. For example, ability to continue as a going concern for a reasonable period of time, not to exceed one year (AU 341.02), can involve a very different timespan than ability to hold a particular impaired security for a period of time sufficient to allow

for the recovery of its fair value (AU 332.47; *see* FD 7). Also, a going-concern analysis can encompass not only plans “to dispose of assets” but also plans “to borrow money or restructure debt,” “to reduce or delay expenditures,” and “to increase ownership equity.” AU 341.07.

The going-concern and OTTI evaluations are distinct processes, governed by substantively different auditing standards, and related to separate financial statement and auditor reporting considerations, one concerning the assumption in financial reporting of an entity’s continuation as a going concern and one concerning its recognition of unrealized losses in its financial statements. FD 92-93. No part of AU 332 or 341 cross references the other, because they relate to different audit objectives. A financial statement audit must include evaluation of whether there is substantial doubt about the company’s ability to continue as a going concern. 15 U.S.C. 78j-1(a)(3); AU 341.02. If substantial doubt exists, the auditor is required to include an explanatory paragraph in the audit report, disclosing that conclusion. AU 341.12; FD 94. That disclosure does not affect the auditor’s opinion on the financial statements. AU 508.11. In contrast, the evaluation of impairment losses and OTTI are part of the auditor’s responsibility to determine whether the financial statements are presented fairly, in all material respects, in conformity with GAAP. AU 332.48. The failure to recognize an OTTI loss in earnings, if material would result in a departure from GAAP, requiring modification of the auditor’s opinion. AU 508.35-.60. Reinhart’s evaluation here concerned Thornburg’s “critical accounting estimate” that \$427.8 million in unrealized losses on its collateralized securities at year end were not other-than-temporarily-impaired based on its “ability and intent to hold” these securities. As a result of that determination, Thornburg did not recognize the losses against its earnings.

Reinhart engaged in no differentiated audit analysis reflecting any of the foregoing, constituting at least two instances of negligence. While information regarding Thornburg’s

liquidity, margin calls, and securities values was pertinent to both evaluations, she needed to examine the circumstances facing Thornburg through the lens of each distinct evaluation. Those aspects had potentially different implications depending on the standard applied. For example, that Thornburg may have been untimely paying margin calls (*see* J-1 at 40) directly contradicted its ability to hold the securities. FD 43-44, 75, 81-82. Such events permitted lenders to liquidate the securities “without Thornburg’s knowledge.” FD 8. Similarly, its perilously low liquidity and the 2-3% information had more immediate implications under AU 332. This is plain from its disclosure that if “we cannot meet future margin calls from our available liquidity, we might need to selectively sell assets...to raise cash.” FD 48, 76. Although selling assets may mitigate a liquidity shortfall for going-concern purposes, it directly undercuts ability to hold those assets.

III. Individual Audit Tasks Underlying Reinhart’s Violations Constitute Repeated Instances of Negligent Conduct.

The Board noted important distinctions, “both factual and in terms of the necessary audit procedures,” bearing on the three aspects Reinhart focused on in each area. *E.g.*, FD 93 & n.39.

Under SEC precedent, individual audit tasks in one audit area “over a short span of time for a single client involving a single audit” (Reply 23) can constitute repeated instances of negligent conduct. *Gregory M. Dearlove* held that the auditor’s “repeated failures” of “most basic auditing principles,” including exercising due professional care, obtaining sufficient competent evidential matter to afford a reasonable basis for an opinion, and maintaining an attitude of professional skepticism, within “each of four auditing areas,” constituted “repeated instances of [negligent] conduct” under SEC Rule 102(e)(1)(B). SEC Rel. No. 34-57244, 2008 WL 281105, *28, *30 (Jan. 31, 2008) (emphasis added). The SEC concluded that the “frequency

and gravity” of the failures necessitated time away from auditing public companies. *Id.*; see SEC Rel. No. 34-40089, 1998 WL 312829, *5 (June 12, 1998) (instances “within one audit”).

Again, in *John J. Aesoph*, the Commission found “numerous instances” of negligent conduct in one “high risk audit area.” SEC Rel. No. 34-78490, 2016 WL 4176930, *14-*16 (Aug. 5, 2016). Although the auditors’ “repeated misconduct” there “occurred in” one audit area, not two as here, the Commission emphasized that the misconduct was concentrated in “three specific” “aspects” of the one area, *i.e.*, the issuer’s “allowance for loan and lease losses.” *Id.* at *1-*2, *6, *14 n.70, *15 n.73, *16. This is consistent with the Board’s attention to the specifics of Reinhart’s assessments, in high-risk areas, of Thornburg’s (1) readily available liquidity, (2) declining securities values, and (3) margin calls, all of which weighed on its financial condition, but to which she failed to apply fundamental auditing principles.

Reinhart’s characterization of her conduct as “failing to adequately consider, in light of contrary evidence, whether the company had sufficient readily available liquidity to meet its financial obligations” (PD 1) is oversimplified. *E.g.*, FD 92; Opp. 42-43. The second half blurs readily available liquidity—defined by Thornburg as its “cash, cash equivalents..., unpledged securities, and unused whole loan financing” (FD 8)—with its “financial obligations,” as relevant here, its margin calls. But the audit circumstances called for more than just tracking at Subsequent Period-end Thornburg’s readily available liquidity, itself something she failed to do. She specifically identified margin calls as a fraud risk, prone to misrepresentation, and sought margin-call information. FD 26. As the August 2007 events showed, untimely meeting calls put Thornburg’s entire rev repo borrowing at risk. They also showed the importance of declining securities values and thus the 2-3% information. Reinhart breaks out none of this.

The first half of the quoted formulation ignores multiple varied, compounding, and high-stakes instances of negligence. These naturally arise from this rich record and bear on the seriousness of the misconduct; they are not “slice[d] and dice[d]” from some monolithic view of the audit work (Reply 23). Such failures pervaded both evaluations at issue, were highly consequential, and indicate a deep-seated, not accidental or isolated, problem in the audit by Reinhart with complying with PCAOB standards.^{3/} This was no “single error that results in an issuer’s financial statements being misstated in more than one place.” FD 91.

For example, Reinhart’s uncritical acceptance of management’s \$150 million assertion showed a glaring lack of professional skepticism. FD 63, 74, 93. And she failed to investigate that assertion despite contrary evidence and the basic precept that management representations are no substitute for necessary auditing procedures. FD 58, 74, 93. Her reliance on the 7% error was a “clear failure to exercise due professional care.” FD 60, 75, 93.

Also, as the Board unanimously found, Reinhart again exhibited a lack of professional skepticism in a high-risk environment by doing nothing with the 2-3% information but accept management representations and a lack of due care by failing to assess that information in light of Thornburg’s available liquidity, while failing to sufficiently test the information, which was contradicted by other audit evidence. FD 60-61, 76, 93. Her lack of attention to the margin-call schedules and cash reports were further failings. She failed to exercise professional skepticism by accepting, without obtaining any margin-call data, management’s excuse for not providing a margin-call list and then failing to react when it later provided responsive data. FD 61, 63, 75,

^{3/} The “repeated instances” language pertains to violative acts, practices, and omissions found in the proceeding at hand, 15 U.S.C. 7215(c)(4)-(5), not whether they represent recidivism over an auditor’s entire career (Reply 23); lack of prior disciplinary history is a separate sanctions argument, which the Board properly rejected (FD 98).

89, 93. She again uncritically accepted management’s claim that the margin calls in the last half of February were “unusual.” FD 61, 75. She ignored the cash settlements instead of using them to check whether margin calls were being met, underscoring her lack of due care, overreliance on representations, and failure to obtain and evaluate audit evidence. FD 62. Similarly, she failed to ascertain Thornburg’s readily available liquidity in the Subsequent Period, despite deliberately “defer[ring] her consideration” (Tr. 137-38)—not her “conclusion” (Reply 18)—of the pertinent issues until late February. FD 14-18, 32, 58, 72-74; R-34 at 1.^{4/}

As the Board unanimously found, the 7% error grossly overestimated Thornburg’s “protection” against future margin calls. Having failed to assess management’s \$150 million representation and Thornburg’s remaining cash, Reinhart lacked clarity on its liquidity at Subsequent Period-end. Her failure to obtain sufficient audit evidence left her unaware Thornburg received nearly \$1 billion in margin calls in that period and was struggling to meet calls in the final week, triggering potential defaults/liquidations, as in August 2007. And she did not engage in any detail on whether Thornburg could even meet margin calls associated with a 2-3% drop (\$250-\$375 million), despite audit evidence showing it had only \$27 million.

Yet, according to Reinhart, despite the fact that over and over again she committed similar failings, that she committed varied failings, and that the failings were serious, none of this matters to the “repeated instances” analysis. Her position is meritless.

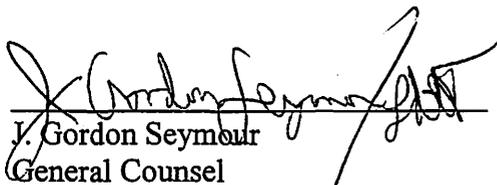
^{4/} Reinhart knew Thornburg’s financial condition had been steadily declining since August 2007 and read internal warnings about the continuing declining markets. And even if many events occurred in the final two weeks, she had to adequately evaluate them before authorizing issuance of an unqualified audit report. FD 97; PD 1. Instead, she authorized its issuance two days ahead of time, to the detriment of investors.

CONCLUSION

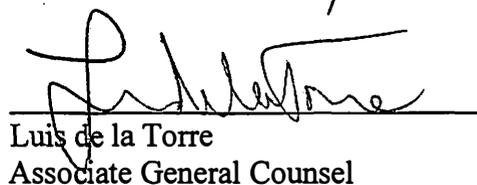
The Commission should sustain the Board's order imposing sanctions for Reinhart's serious violations to protect investors and further the public interest.

Dated: December 22, 2017

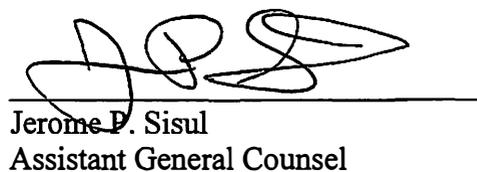
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CERTIFICATION OF COMPLIANCE WITH RULE 450(c)

I, Luis de la Torre, certify that the foregoing Sur-Reply complies with the word count limitations set forth in Rule 450(c) of the Commission's Rules of Practice, 17 C.F.R. 201.450(c), and that the foregoing brief contains 6,999 words, exclusive of pages containing the Table of Contents and Table of Authorities, as counted by the Word Count feature of our Microsoft Word word-processing program used to prepare the brief.



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CERTIFICATE OF SERVICE

I hereby certify that on the 22nd of December, 2017, I caused to be sent to George A. Salter and Ira M. Feinberg via Federal Express a copy of the foregoing Sur-Reply and accompanying certification of compliance (filing of which is made today by facsimile transmission to the Commission's Office of the Secretary, 202-772-9324, with the original and three paper copies transmitted today to that Office by Federal Express) addressed as follows:

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I am also transmitting today courtesy copies of the brief and notice of appearance to the above-named counsel at george.salter@hoganlovells.com and ira.feinberg@hoganlovells.com.



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