INITIAL DECISION RELEASE NO. 624
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15168

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of :
:
JOHN J. AESOPH, CPA, and : INITIAL DECISION
DARREN M. BENNETT, CPA : June 27, 2014

APPEARANCES: Thomas J. Krysa, Nicholas P. Heinke, and Gregory A. Kasper for the Division of Enforcement, Securities and Exchange Commission

George B. Curtis, Scott A. Fink, and Monica K. Loseman,
Gibson, Dunn & Crutcher LLP, for Respondent John J. Aesoph, CPA

Gary F. Bendinger, Kevin A. Burke, and Benjamin J. Hoffart,
Sidley Austin LLP, for Respondent Darren M. Bennett, CPA

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision sanctions John J. Aesoph, CPA (Aesoph), and Darren M. Bennett, CPA (Bennett) (collectively, Respondents), in connection with their roles as engagement partner and manager of the audit of the 2008 financial statements of TierOne Corporation, a holding company for TierOne Bank (collectively, TierOne). This Initial Decision denies Aesoph the privilege of appearing or practicing before the Securities and Exchange Commission (Commission) as an accountant for one year, and denies Bennett the privilege of appearing or practicing before the Commission as an accountant for six months.

I. INTRODUCTION

A. Procedural Background

The Commission initiated this proceeding on January 9, 2013, by an Order Instituting Proceedings (OIP), pursuant to Section 4C of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78d-3, and Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e) (Rule 102(e)).

The undersigned held nine days of hearing in Denver, Colorado, on October 7-11 and 28-31, 2013. The Division of Enforcement (Division) called five witnesses from whom testimony was taken, including Respondents and two experts. Respondents testified in their own cases and called two experts. Numerous exhibits were admitted into evidence.[1]

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 101-04 (1981). Pursuant to the Administrative Procedure Act,[2] the following post-hearing pleadings were considered: (1) the Division's Proposed Findings of Fact and Conclusions of Law, Opening Brief in Support of Its Findings of Fact and Conclusions of Law, and Reply Brief in Support of Its Findings of Fact and Conclusions of Law; (2) Respondents' Joint Proposed Findings of Fact and Conclusions of Law; (3) Respondent Aesoph's Post-Hearing Brief, and Post-Hearing Reply Brief; and (4) Respondent Bennett's Post-Hearing Brief, and Post-Hearing Reply Brief. All arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

Respondents are charged with improper professional conduct, Aesoph as engagement partner, and Bennett as senior manager, within the meaning of Rule 102(e) and Exchange Act Section 4C, in connection with the December 31, 2008, year-end audit of TierOne's financial statements. Specifically, the OIP alleges that Respondents failed to comply with Public Company Accounting Oversight Board (PCAOB) auditing standards because they failed to subject TierOne's loan loss estimates – one of the highest risk areas of the audit – to appropriate scrutiny.[3] The Division urges that Aesoph be denied the privilege of appearing or practicing before the Commission for a period of three years and Bennett, for a period of two years.

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[1] Citations to the hearing transcript will be noted as "Tr. ___." Citations to exhibits offered by the Division and Respondents will be noted as "Div. Ex. ___" and "Resp. Ex. ___," respectively. Citations to Bates-stamped pages will be noted without reference to the Bates number's prefix.

[2] See 5 U.S.C. § 557(c).

[3] Pursuant to the PCAOB's Auditing Standard No. 1, what were known as Generally Accepted Auditing Standards (GAAS) were adopted as PCAOB standards, subject to being superseded going forward. PCAOB; Order Approving Proposed Auditing Standard No. 1, 69 Fed. Reg. 29149 (May 20, 2004). GAAS were the standards prescribed by the Auditing Standards Board of the American Institute of Certified Public Accountants for the conduct of auditors in the performance of an examination of financial statements. See In re Ikon Office Solutions, Inc., 277 F.3d 658, 663 n.5 (3d Cir. 2002) (citing SEC v. Arthur Young & Co., 590 F.2d 785, 788 n.2 (9th Cir. 1979)). The ten GAAS are further defined or interpreted by Statements on Auditing Standards (SAS), which are codified in the Codification of Statements on Auditing Standards, as "AU § ___." The professional standards cited in this Initial Decision are those in effect during the time of the conduct at issue, which is October 2008 to March 2009 for the audit and April 2009 for the subsequent discovery of facts.

Respondents argue that they did not engage in improper professional conduct and ask that the proceeding be dismissed.

C. Procedural Issues

1. Due Process

Bennett argues that the manner in which the Division conducted its investigation and sought to prove its case violated due process. He states that the Division did not obtain loan files for two-thirds of the loans at issue during its investigation, which deprived Bennett of a fair opportunity to prepare and present his defense. However, the Division's investigation and presentation of evidence fell within its prosecutorial discretion, and disagreements regarding the evidence are best left to be resolved at the hearing. See Kevin Hall, CPA, Exchange Act Release No. 61162 (Dec. 14, 2009), 97 SEC Docket 23679, 23712-13; Armstrong, Jones & Co., 43 S.E.C. 888, 901-02 (1968), aff'd, 421 F.2d 359 (6th Cir. 1970). Nor has Bennett established any prejudice to his defense; he had the full opportunity to point to information in the loan files to justify his conduct. See Kevin Hall, CPA, 97 SEC Docket at 23714; Jonathan Feins, 54 S.E.C. 366, 378 (1999) ("Administrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding.").

Bennett also contends that the Division's interpretations of accounting principles and auditing standards contravene accepted interpretations within the profession, and a Rule 102(e) finding based on the Division's "novel interpretations" would amount to impermissible rulemaking by enforcement, violating his due process rights by depriving him of notice of the standards against which his professional conduct is to be judged. He states that the Division suggested in its closing argument that "fair value" measurements ought not to exclude the impact of disorderly sales in times of economic turmoil, which he argues contravenes Statement of Financial Accounting Standards No. (FAS) 157. Respondents' liability in this Rule 102(e) proceeding is predicated on PCAOB auditing standards of which they had ample notice. See Marrie v. SEC, 374 F.3d 1196, 1203-06 (D.C. Cir. 2004). They raised FAS 157 in defense of the charges. The undersigned does not hold Respondents liable on the basis of including or excluding disorderly transactions in their review of market data. Additionally, "rulemaking by enforcement" is not "impermissible." "[T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency." SEC v. Chenery Corp., 332 U.S. 194, 203 (1947); see Shalala v. Guernsey Mem'l Hosp., 514 U.S. 87, 96 (1995) ("The [Administrative Procedure Act] does not require that all the specific applications of a rule evolve by further, more precise rules rather than by adjudication.").

Additionally, Bennett takes issue with statements made by the Division that, he claims, suggest that the auditors should be responsible for "auditing" each of TierOne's loan loss reserve estimates, whereas under PCAOB standards "[t]he auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole." AU § 342.04. The Division, however, contends that in order to evaluate the reasonableness of the estimates in the context of the financial statements taken as whole, they were required to evaluate those estimates on a loan-by-loan basis, which Respondents conceded.

2. Expert Testimony and Report

Respondents renew their motion to exclude Anjan V. Thakor's testimony and expert report, for the reasons stated in their First Joint Motion in Limine – To Exclude the Report and Testimony of Anjan V. Thakor, filed on August 30, 2013. The motion is again denied, as it was at the September 23, 2013, prehearing conference. John J. Aesoph, CPA, Admin. Proc. Rulings Release No. 898, 2013 SEC LEXIS 2846 (A.L.J. Sept. 24, 2013), Prehr'g Tr. 3-4; see 17 C.F.R. § 201.320; Herbert Moskowitz, 55 S.E.C. 658, 685 n.68 (2002); City of Anaheim, 54 S.E.C. 452, 454 & n.7 (1999). To the extent Respondents disagree with Thakor's methodology and opinions, they had the opportunity to address such issues by cross examination, with expert testimony, and in their briefs.

II. FINDINGS OF FACT

A. TierOne, Respondents, and Other Relevant Persons and Entities

1. TierOne

TierOne was a regional bank headquartered in Lincoln, Nebraska, that originated and purchased loans, and loan participation interests, with its primary market area in Nebraska, Iowa, and Kansas. Div. Ex. 91 at 13; Div. Ex. 130 at 5-7.[4] From 2002 to 2005, TierOne opened or acquired nine loan production offices (LPOs) in Arizona, Colorado, Florida, Minnesota, Nevada, and North Carolina (LPO States), the main purpose of which was to originate construction and land-development loans. Div. Ex. 91 at 13; Div. Ex. 128 at Ex. No. 99.1. Over time, TierOne increased its portfolio in these high-risk loans. Div. Ex. 130 at 7-9, 11; see Div. Ex. 91 at 3. By September 2008, TierOne closed the LPOs, in the wake of real estate market deterioration. Div. Ex. 130 at 5, 61. By year-end 2008, TierOne had a total net loan portfolio of approximately $2.8 billion, with a quarter of its loans concentrated in the LPO States. Id. at 11-12.

KPMG LLP (KPMG) audited TierOne's 2008 financial statements. Div. Ex. 130 at 89. TierOne's primary federal regulator was the Office of Thrift Supervision (OTS), the entity charged with examination of federal and state savings associations.[5] Tr. 1406. In October 2008, OTS issued a report of examination (OTS report or the report) following its June 2008 examination of the bank, in which it downgraded TierOne's bank rating; criticized management and loan practices; and found that the bank had collateral-dependent loans either without appraisals or with unsupported or stale appraisals. Div. Ex. 81 at i-ii, 1-4, 11-12, 15, 17, 23-24; Tr. 1413-15.

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[4] Div. Ex. 130 is TierOne's year-end 2008 Form 10-K. Citations are to the page numbers in the upper left corner of the exhibit.

[5] OTS has since been integrated with the Office of the Comptroller of the Currency. Tr. 1406.

In March 2009, KPMG issued an unqualified opinion (audit opinion) on TierOne's consolidated financial statements and effectiveness of its internal controls over financial reporting as of year-end 2008; certified that the audit was conducted in accordance with PCAOB standards that required KPMG to plan and perform the audit to obtain reasonable assurance whether the financial statements were free of material misstatement; and opined that the financial statements reflected in TierOne's year-end 2008 Form 10-K (2008 Form 10-K) presented fairly, in all material respects, the financial position of TierOne and the results of its operations and cash flows, in conformity with U.S. Generally Accepted Accounting Principles (GAAP). Div. Ex. 130 at 89.

Subsequently, TierOne recorded $120 million in losses relating to its loan portfolio after obtaining updated appraisals. Div. Ex. 91 at 5; Tr. 931-33. In April 2010, KPMG learned that TierOne had failed to disclose a document created by management in the first-quarter of 2009 (Q1 2009) showing an internal analysis of varying estimates of additional loan loss reserves higher than what had been disclosed during the audit. Tr. 1751-58; Div. Ex. 136 at 2. That same month, KPMG resigned from the TierOne engagement and withdrew its audit opinion relating to: (1) TierOne's year-end 2008 financial statements because they contained "material misstatements related to certain out of period adjustments for loan loss reserves," and (2) TierOne's internal controls "due to a material weakness in internal control over financial reporting related to the material misstatements." Div. Ex. 135 at 2-3 & Ex No. 99.3.[6]

In June 2010, OTS closed TierOne. Div. Ex. 91 at 1. In 2011, the Department of Treasury's Office of Inspector General issued a report finding that: TierOne failed primarily because of significant losses in its construction and land-development loan portfolio, originated largely through the LPOs; and TierOne management often failed to order updated appraisals when modifying loans or when material deterioration in property values was evident. Id. at 2-3, 5.

In 2012, the Commission filed complaints in federal district court against three former TierOne executives, alleging, among other violations, fraud and deceit of auditors in connection with TierOne's loan-related losses. Resp. Ex. 234 at 1-4, 7-20, 24-27; Resp. Ex. 235 at 1, 4, 9-28. Without admitting or denying the allegations, two of those executives consented to the entry of judgment enjoining them from violations of the antifraud and other provisions of the federal securities laws and imposing civil penalties; the case against the third remains pending. See Final Judgment as to Defendant Gilbert G. Lundstrom, and Final Judgment as to James A. Laphen, SEC v. Lundstrom, 12-cv-343 (D. Neb. Sept. 26, 2012), ECF Nos. 10, 15; Docket Sheet, SEC v. Langford, 12-cv-344 (D. Neb.); 17 C.F.R. § 201.323 (Official Notice).

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[6] Div. Ex. 135 is TierOne's April 23, 2010, Form 8-K. Citations are to the page numbers in the upper left corner of the exhibit.

2. Aesoph

Aesoph is an audit partner at the Omaha, Nebraska, office of KPMG, and he served as the engagement partner of the 2008 TierOne audit. Tr. 726, 895-96, 1731-32. As engagement partner, he had full responsibility for KPMG's audit opinion and final authority over the planning, execution, and supervision of the audit; he was responsible for ensuring that the audit engagement team complied with professional standards and adequately documented the evidence on which they relied. Tr. 725-27, 895-96.

Aesoph graduated from the University of South Dakota in 1994 with a degree in accounting and began his public accounting career in 1996. Tr. 1731. He has worked at KPMG since 2001 and was promoted to partnership in 2005. Tr. 1731. Since joining KPMG, he has primarily audited banks and other financial services-related entities. Tr. 1731-32. He was the manager of TierOne's audits from 2002 to 2005, and the engagement partner from 2006 until KPMG resigned in 2010. Tr. 1734-35. He earned 278 credit hours of continuing professional education (CPE) during the 2006 to 2008 period, exceeding the required 120 credit hours. Tr. 1734; Resp. Ex. 203 at 1. The CPE included topics specific to the banking industry, professional standards, and auditing fair value estimates. Resp. Ex. 203 at 2-5. To keep abreast of issues related to the 2008 credit crisis and economic climate, he attended conferences sponsored by the Federal Deposit Insurance Corporation, and participated in internal meetings and conference calls. Tr. 1732-34. Prior to the 2008 TierOne audit, KPMG gave him less than satisfactory ratings on the audit engagements of two privately held companies, due to the lack of performance and/or documentation of effective, substantive analytical procedures on revenue and other income-statement accounts. Div. Ex. 109 at 1, 5; Tr. 724-25. Except for the events at issue, he has not been the subject of any regulatory investigation or proceeding. Tr. 1802.

3. Bennett

Bennett served as the senior manager of the 2008 TierOne audit and reported directly to Aesoph. Tr. 353-54. As senior manager, he was responsible for supervising the engagement team's day-to-day work, and for performing the audit in accordance with professional standards. Tr. 353-54, 358-60, 1676-79, 1719-20.

Bennett graduated in 1999 from the University of Nebraska at Lincoln (UNL), where he studied business administration with an emphasis in accounting; he earned a master's degree in professional accountancy from UNL in 2000 and became a CPA in 2006. Tr. 1520-21. He began working full time at KPMG in 2001 and was promoted to senior manager in his sixth year. Tr. 1524-25. He was involved in about thirty audits prior to the audit at issue. Tr. 1525. His first involvement with a TierOne audit was in 2003. Tr. 1526. He earned 267 CPE credit hours during the 2006 to 2008 period. Tr. 1522-23; Resp. Ex. 208 at 1. His coursework included issues specific to the banking industry, professional standards, auditing fair value estimates, and the economic environment. Resp. Ex. 208 at 2-5. Except for the events at issue, he has not been the subject of any regulatory or disciplinary proceeding. Tr. 1518, 1521.

4. Engagement Team

The engagement team assigned to the audit included Aesoph and Bennett; Beth Burke (Burke) and another auditor, both of whom reported to Bennett; Sandra Washek (Washek), a credit specialist; an SEC reviewing partner; forensic specialists; members of KPMG's financial services regulatory practice (regulatory group); and others. Resp. Ex. 3 at 3655-57; Tr. 354, 480-81.

B. TierOne's Loan-Related Losses

At issue is TierOne's allowance for loan and lease losses (ALLL), a balance-sheet reserve account intended to cover known and inherent losses in TierOne's loan portfolio. Div. Ex. 130 at 22, 24-25, 63; Div. Ex. 118 at 3678-79. The ALLL consisted of two main portions: losses for unimpaired loans evaluated under FAS 5, and losses for impaired loans evaluated under FAS 114.[7] Div. Ex. 120 at 5434-35; Div. Ex. 130 at 24; Tr. 361-62. Respondents' review and test of the FAS 114 portion of the ALLL, in connection with the audit, is the only component at issue.

Related to the ALLL is TierOne's provision for loan losses (provision), an income-statement account in which losses are charged to earnings. Div. Ex. 130 at 22, 25; Div. Ex. 118 at 3683-84. TierOne established provisions to maintain the ALLL at a level management believed would cover all known and inherent losses in TierOne's portfolio that were both probable and reasonable to estimate at each reporting date. Div. Ex. 130 at 75. Another element involved charge-offs to the loan balance. Div. Ex. 130 at 25, 63; see Tr. 767, 953-55. When TierOne determined that additional reserves for loan losses were necessary, it would increase the provision by debiting the income statement and increase the ALLL by crediting the balance sheet. Tr. 627-29, 768-70, 995. Once the loss (such as a collateral deficiency) was provisioned for on the income statement and deemed confirmed, TierOne charged-off the loss amount from the loan balance, thus reducing the ALLL.[8] Tr. 628, 767, 953-55; cf. Div. Ex. 120 at 5434.

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[7] FAS 5 sets forth standards of financial accounting and reporting for loss contingencies. FAS 5 ¶ 6 (Resp. Ex. 46 at FAS5-4). The ALLL on FAS 5 loans was driven by risk ratings and loss factors; appraised values of collateral did not drive losses on FAS 5 loans, and appraisals were not used to value FAS 5 loans. Tr. 363-64, 368. FAS 114 sets forth standards of accounting by creditors for impairment of a loan. FAS 114 ¶ 5 (Resp. Ex. 44 at FAS114-3).

[8] In the second quarter of 2008, TierOne began provisioning losses to the income statement and charging off losses from the balance sheet simultaneously. Tr. 767-68, 955. Previously, TierOne would carry the reserves on its balance sheet, in the ALLL, until the subject property was foreclosed; at that time, the loan balance would be charged-off and the property would be reclassified on the balance sheet under the account "other real estate owned." Tr. 767-68. TierOne could not charge off losses before they were incurred, such as based on a prediction that the market would keep going down. Tr. 569-70. FAS 5 and FAS 114 require that a loss contingency be both probable and reasonably estimable. FAS 5 ¶¶ 8, 84 (Resp. Ex. 46 at FAS 5-5, FAS 5-18); FAS 114 ¶¶ 8, 10 (Resp. Ex. 44 at FAS 114-4, FAS 114-5).

TierOne's ALLL was critical to the portrayal of its financial condition and a significant focus of the audit. Div. Ex. 117 at 2464; Tr. 360-61, 385-87. As an initial step in determining the ALLL, TierOne management undertook an evaluation of the bank's loan portfolio each quarter, including both a quantitative and qualitative analysis. Div. Ex. 115 at 1753; Div. Ex. 120 at 5433-34.

Under FAS 114, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. FAS 114 ¶ 8 (Resp. Ex. 44 at FAS114-4). Under TierOne's methodology, all loans past-due ninety days or more were deemed impaired; management reviewed other delinquent loans to determine whether it was probable that TierOne would not collect all amounts due; and TierOne's Asset Classification Committee (ACC), which consisted of eleven members of TierOne management, conducted a high-level review of credit and delinquency reports relating to the ALLL. Tr. 819-20, 972-73; Div. Ex. 119 at 5017, 5056-60; Div. Ex. 120 at 5434, 5484.

For FAS 114 loans, TierOne estimated the ALLL on a loan-by-loan basis, using a collateral-dependent fair value model for impaired, non-homogenous loans with a balance exceeding $1 million. Tr. 434, 498-99, 850-51; Div. Ex. 120 at 5434. At year-end 2008, TierOne management documented its estimates in fifty-four FAS 114 templates; each template contained loans associated with an individual lending relationship or borrower, meaning that one template might aggregate several loans for one borrower.[9] Tr. 498; Div. Ex. 120 at 5434, 5485-5548.

On each FAS 114 template, TierOne calculated the ALLL for each loan (and total position as to the borrower) by subtracting, from the estimated book value of the loan, the present value of the proceeds of the collateral securing the loan (collateral value). Tr. 364-67, 861-62; see, e.g., Div. Ex. 120 at 5485. The book value was the loan's original value minus any charge-offs that occurred in prior periods; such charge-offs were reflected on the templates as "specific reserves." Tr. 367; see, e.g., Div. Ex. 120 at 5485. The collateral value was the estimated fair value of the collateral underlying the loan minus the selling costs (or estimated cost to foreclose) and discounting the number of months to sell the collateral. Tr. 647-49, 691; Div. Ex. 120 at 5485. For FAS 114 loans, TierOne used appraisals to determine the estimated fair value of the collateral. Tr. 367-68, 862-63; see FAS 114 ¶ 13 (Resp. Ex. 44 at FAS114-5) ("[A] creditor shall measure impairment based on . . . the fair value of the collateral if the loan is collateral dependent.").

KPMG categorized the templates prepared by TierOne into three "buckets": (1) impaired loans in which the collateral value was lower than the book value, resulting in year-end losses and required reserves (bucket one); (2) impaired loans in which the collateral value exceeded the

[9] In addition to the impaired loans identified by management, TierOne's internal audit group identified loans associated with another borrower that were deemed impaired at year-end. Tr. 834; Div. Ex. 120 at 5374-80.

book value, resulting in no required reserves (bucket two); and (3) loans evaluated for impairment, but eventually deemed unimpaired (bucket three).[10] Div. Ex. 120 at 5484; Tr. 532-33, 842. If the collateral value declined further below the book value for a bucket one loan, there would be additional losses and the required ALLL would increase, regardless of prior charge-offs. Tr. 366-67, 532. Collateral values drove losses on TierOne's FAS 114 loans because most of those loans were collateral dependent, meaning loan repayment was expected to be provided through foreclosing on and selling the underlying collateral. Tr. 364, 434, 488; see FAS 114 ¶ 13 (Resp. Ex. 44 at FAS114-5).

In its 2008 Form 10-K, TierOne reported that as of year-end, it had $185.9 million in impaired loans, an increase of over 47% compared to year-end 2007. Div. Ex. 130 at 63. It also reported that its total ALLL was $63.2 million, of which $16.4 million was for impaired loans, and that its charge-offs totaled $90.4 million. Id.

C. OTS Report and Resulting Capital Requirements

The OTS report made apparent that TierOne's loan portfolio was in a troubled state, due to management failures and the bank's concentration in high-risk loans in certain LPO States. Specifically, OTS found: TierOne's board and management were "exceptionally poor" in their performance and had breached their fiduciary duty to exercise the highest standard of care in the conduct, management, and oversight of bank affairs; credit underwriting practices were "deficient" and credit administration practices "inept"; and TierOne's ability to maintain appropriate capital and allowance levels depended greatly on management's ability to successfully work out the existing asset problems in Las Vegas, Nevada, and Florida, and to preclude development of significant problems in other weak markets. Div. Ex. 81 at 2-3. OTS noted that TierOne's concentration in construction, land, and land-development loans accounted for the largest share of provisions, and the large investment in loans secured by properties in declining real estate markets, such as southwest Florida and Las Vegas, exacerbated those losses. Id. at 11.

Further, OTS found: the bank's "deteriorating financial condition" was principally the result of poorly administered concentrations of higher risk credits in rapidly flagging markets that were previously hotbeds for lending activity; and management had failed to satisfactorily monitor, assess, and respond timely to the impact of such weakening markets on the adequacy of the ALLL and capital.[11] Id. at 23.

[10] Bucket three loans were returned to the FAS 5 portion of the ALLL. Tr. 533.

[11] Unfortunately, TierOne management had relinquished managerial and oversight control of the Las Vegas LPO to that office's regional construction lending manager, which fostered an environment defined by reckless, high-risk lending activities and a blatant disregard for prudent credit administration procedures, fueled by a compensation package that rewarded him for production and preapproved extensions of credit with no consideration of loan performance and asset quality. Div. Ex. 81 at 23.

Although OTS identified a deficiency in TierOne's ALLL ranging between $17 and $22 million as of March 31, 2008, it concluded that TierOne addressed its concerns by recording additional provisions and charge-offs; as a result, it deemed the ALLL was appropriate as of June 30, 2008.[12] Id. at 15, 55. However, OTS found that the ALLL and valuation allowances were deficient, and that ALLL methodology required enhancement; OTS stated that the significant decline of real estate values in certain markets necessitated a higher level of ALLL than supported by historical losses. Id. at 11-12, 15, 17.

As a result of the examination, OTS downgraded TierOne to a composite CAMELS rating of 4 (the second lowest rating), down from a rating of 1 in 2007.[13] Id. at ii, 1, 68; Tr. 1414-15. Further, OTS increased TierOne's regulatory capital requirements: its core capital ratio was set at 8.5%, and its total risk-based capital ratio at 11%. Div. Ex. 130 at 125-26; Div. Ex. 81 at 3. In January 2009, TierOne entered into a supervisory agreement with OTS – a formal enforcement action for troubled institutions. Tr. 1420-21; see Div. Ex. 87. Among the requirements, TierOne was directed to establish procedures that required current and well-supported appraisals on applicable loans. Div. Ex. 87 at 7-8.

At year-end 2008, TierOne's core capital exceeded the required amount of $281 million by $12.4 million and its risk-based capital exceeded the required amount of $314 million by $15.8 million. Div. Ex. 130 at 126. Its core capital ratio exceeded the required 8.5% by 0.4%, and its risk-based capital ratio exceeded the required 11% by 0.6%. Id. These figures would be directly impacted by additional provisions; in other words, if TierOne recorded more loan losses, its capital ratios would go down. Tr. 451-52, 455. And if TierOne failed to meet its capital requirements, OTS could take enforcement action against the bank, which included imposing civil penalties, appointing a receiver, or requiring TierOne to merge with another bank. Div. Ex. 130 at 40; Tr. 452.

D. Respondents' Audit of TierOne's 2008 Financial Statements

Respondents started planning TierOne's 2008 audit in October 2008. Tr. 415. Their cumulative knowledge from their prior audits of TierOne informed their planning of, and judgments during, the audit. Tr. 436, 1526-27, 1734-35. At issue are Respondents' conduct related to their test of the effectiveness of TierOne's internal controls over its financial reporting,

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[12] OTS did not evaluate the adequacy of the ALLL after June 30, 2008, or at year-end 2008. Tr. 444, 1418.

[13] CAMELS is an acronym for the components of the OTS examination: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Tr. 1411; Div. Ex. 81 at 1. A composite CAMELS rating of 4 is given to a financial institution that has "unsafe and unsound practices or conditions," serious financial or managerial deficiencies, and a distinct possibility of failure if the identified problems and weaknesses are not satisfactorily addressed and resolved. Div. Ex. 81 at 68.

and their review and test of the process used by management to develop the ALLL estimate as to the FAS 114 loans. Tr. 354, 367, 444-45, 711-13.

The auditors gained understanding of how TierOne management conducted its accounting and performed walkthroughs of the entire loan process of initiating, authorizing, processing, recording, and reporting individual transactions (or estimates) and controls, including antifraud controls. Resp. Ex. 7 at 5004; see id. at 5004-28; Tr. 1582-83. They reviewed management's documented analysis explaining its ALLL process (ALLL Memo). Div. Ex. 120 at 5432-69; Tr. 705. They performed various procedures in their substantive review and test of management's ALLL estimate, as documented in the work papers. See, e.g., Div. Ex. 120 at 5276-78, 5424-31, 5482-83, 5564-94.

At the conclusion of the audit in March 2009, Respondents signed off that all necessary auditing procedures were completed, review notes were cleared, support for conclusions was obtained, sufficient appropriate audit evidence was obtained, and documentation was prepared and reviewed to support the representations in their report. Div. Ex. 118 at 3426. Respondents testified to the importance and their awareness of audit documentation standards. Tr. 485-86, 1677-80, 1763-64; see generally Auditing Standard (AS) No. 3. Bennett testified that all of the work that the engagement team did to test TierOne's process for evaluating FAS 114 loans was documented. Tr. 713-14. Aesoph believed that the engagement team documented, and expected that the engagement team document, the evidence used in arriving at its audit judgments. Tr. 1763-64.

1. Planning and Risk Assessment

a. Risks Associated with the ALLL

Respondents knew that close scrutiny was required given the risks associated with the ALLL. In planning the audit, the auditors identified the risk of the ALLL being improperly calculated or monitored, or inadequate, as a risk at the financial statement level that could result in a material misstatement or material weakness. Div. Ex. 118 at 3675; Tr. 771-72. The ALLL was the only balance sheet account with an identified high inherent risk of error and an identified risk of fraud.[14] Div. Ex. 118 at 3677-83; Tr. 391-94. Given such risks, Respondents acknowledged the heightened importance under professional standards to exercise professional skepticism, corroborate management representations, and perform more extensive audit procedures and obtain more persuasive evidence. Tr. 358-61, 394-95, 486-87, 773, 776-77; see AU §§ 230.07, 312.17, 316.27, 333.02.

KPMG established a $1.9 million materiality threshold in planning the audit, applied that figure when performing substantive audit procedures, and did not adjust that figure at the conclusion of the audit. Tr. 779, 1705; Div. Ex. 118 at 3653. The FAS 114 portion of the ALLL had a high risk of error and fraud, and was individually material to TierOne's financial

[14] A risk of fraud meant that TierOne might intentionally understate the ALLL, whereas an error is an unintentional misstatement. Tr. 392, 775.

statements. Tr. 780-83, 1716-18. The FAS 114 portion was a significant estimate because of the risk related to collateral valuation. Tr. 398. As Aesoph acknowledged, KPMG needed to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, the FAS 114 portion of the ALLL, in order to gain reasonable assurance that the ALLL was not misstated at year-end, and failing to do either would mean that KPMG did not have a reasonable basis for its audit opinion. Tr. 1799-1801.

At a November 2008 engagement team meeting, Aesoph discussed, based on Bennett's prepared agenda, the need to evaluate evidence critically as a fraud consideration, particularly the reasonableness of management's assumptions used to develop significant estimates. Tr. 396-98; Resp. Ex. 227 at 17561. Additionally, the involvement of KPMG forensic specialists was triggered due to TierOne's risk score. Tr. 400-02. In early December 2008, Bennett participated in a brainstorming session with the forensic specialists, which included discussion of market conditions and asset valuation, as industry-specific fraud considerations; and that "[p]ast environment encouraged lending to higher risk borrowers – consider impact on loss reserves and collateral values," as a client-specific fraud consideration. Resp. Ex. 184 at 93077-78; see id. at 93070; Tr. 398-400, 405-08. Bennett also reviewed Burke's response memorandum to the TierOne client risk assessment summary, which stated that in response to the economic downturn in the banking industry driven by delinquencies in the real estate market, KPMG had increased its procedures surrounding loans and the ALLL calculation, and in response to management's increased pressure to improve financial performance, KPMG would audit estimates such as the ALLL with an increased sense of professional skepticism and ensure that all estimates were reasonable and adequately supported. Div. Ex. 118 at 3697-99; Tr. 412-14. Respondents implemented new or enhanced audit procedures and increased their work hours relative to the prior year. See, e.g., Tr. 1568-70, 1721-25; Resp. Exs. 197, 262; Div. Ex. 118 at 3651-52, 3689.

b. Review of OTS Report

In October 2008, Respondents received the OTS report, which they reviewed in connection with planning the audit. Tr. 415-16, 738-39. Both took the report seriously and were fully aware of its findings. Tr. 416-20, 429-36, 443-44, 739-45. Aesoph understood that TierOne had an incentive to understate losses as a result of its increased capital requirements, and could be reluctant to book reserves in order to retain capital and reduce losses. Tr. 756-57, 764-65, 844. Respondents provided the report and related documents to KPMG's regulatory group for review of TierOne's regulatory risk. Div. Ex. 85 at 1491; Tr. 455, 759-61. In a memorandum issued in late October 2008, the regulatory group concluded that the report and related documents indicated that the bank's regulatory risk was high and its condition had rapidly deteriorated due to unmanaged growth in commercial real estate lending in "bubble markets," such as Las Vegas and Florida, but that the bank was not in imminent danger of failure within the next twelve months. Div. Ex. 85 at 1491, 1493; see Tr. 456-60.

On a phone call in February 2009, Douglas Pittman, the OTS field manager who conducted the 2008 examination and was responsible for overseeing the bank's progress, told Respondents that he was receiving TierOne's responses to OTS comments in a timely manner and its submissions to date were satisfactory. Div. Ex. 117 at 2573; Resp. Ex. 152; Tr. 423-24, 1427-28. However, he anticipated that OTS would not review TierOne's new policies or procedures until later in 2009, and he gave no indication that the ALLL was adequate at year-end 2008, the issues identified in the OTS report had been fully corrected, or TierOne's actions were effective. Div. Ex. 117 at 2573; Tr. 424-28, 1428-32.

2. Internal Controls

KPMG identified the ALLL as having a risk that the collateral securing loans may be overvalued. Div. Ex. 120 at 5188; Tr. 488. This risk impacted FAS 114 loans because collateral overvaluation could result in losses on those loans being understated, which was acute for loans in buckets one and two. Tr. 398, 778-79, 812-13, 843-44. Using stale appraisals to value collateral was a risk associated with the ALLL. Tr. 805, 812. In fact, Washek cautioned that additional testing needed to be done with respect to ordering appraisals, and that TierOne was not ordering new appraisals on substandard loans and there was a risk that collateral was overvalued. Tr. 480-84; Div. Ex. 38 at 271818; Div. Ex. 39 at 271901A. Moreover, as noted in its audit results, KPMG recognized that the ALLL was significantly affected by TierOne's judgment in "[v]aluing the underlying collateral securing the loan (use of appraisals)." Div. Ex. 117 at 2417; see id. at 2406; Tr. 386-87.

KPMG identified "appraisal review" (Control Lot 7-2), performed by management and independently tested by the auditors, as the internal control addressing the risk of collateral overvaluation. Tr. 812; Div. Ex. 120 at 5188-89; Resp. Ex. 7 at 5086-93. However, the purpose of this control was not to assess whether appraisals were current or still valid at year-end, but whether TierOne obtained and reviewed appraisals when loans were originated.[15] Tr. 491-92, 814-15. Other ALLL-related controls that were independently tested by the auditors either did not effectively address the risk of collateral overvaluation or were not relied on by the auditors at year-end. Tr. 490, 492-97, 816-21; see Div. Ex. 119 at 5054-57, 5074-77, 5078-85, 5117-23; cf. Div. Ex. 108; Resp. Exs. 141, 142. For example, TierOne's controller, David Kellogg (Kellogg), reviewed ALLL calculations on a quarterly basis and noted to the auditors that the ACC discussed "recent trends, status changes within the portfolios, reserves modifications, and FAS 114 impairments." Div. Ex. 119 at 5056-57, 5076. But the record does not indicate that Kellogg or the ACC performed any specific procedures to effectively address collateral overvaluation.

3. Review and Test of FAS 114 Portion of the ALLL

a. Economic Considerations

Aesoph acknowledged that professional standards required the auditors to consider market data when reviewing TierOne's fair value estimates under FAS 114 and that management's assumptions relating to those estimates must be consistent with market data and the economic environment. Tr. 727-28; see AU § 328.26, .29, .31, .36(a)-(b); AU § 342.11(d).

[15] In testing this control, KPMG noted that appraisals were not current in all cases, but that this was not a deficiency because "management estimate[d] and document[ed] [its] rationale supporting valuation in these cases," with no further explanation. Resp. Ex. 7 at 5093.

Respondents knew that the deteriorating economic conditions in 2008 – including record real estate market declines in Nevada, Arizona, and Florida – were driving loan impairment and loan loss reserves. Tr. 380-81, 461-64, 467-69, 475-78, 634, 732-33; Div. Ex. 14 at 107489. There is no dispute that there were declines from quarter to quarter in 2008 and that the second half of the year was economically worse than the first half. Tr. 476-77, 784-85. In the TierOne ALLL Memo, management stated that over 80% of the collateral underlying impaired loans was located in the LPO States. Div. Ex. 120 at 5436. Management also represented that market data and analyses showed that three of those states with a sizable share of impaired loans – Nevada, Arizona, and Florida – remained economically weak and had declining property values, and that one report stated that Nevada's economy continued to deteriorate in late 2008. Id. at 5436-37, 5449-52, 5457-58, 5460. In terms of total impaired loan balance, Nevada loans represented over half of the loans reviewed for impairment. Id. at 5484, 5574, 5590-91, 5594.

b. FAS 114 Procedures Memo

Included in the work papers is the FAS 114 procedures memo, the purpose of which was to document KPMG's procedures to audit the FAS 114 calculations at year-end.[16] Div. Ex. 120 at 5482-83; Tr. 824. Aesoph testified that it was the "overall memo" concerning the FAS 114 procedures. Tr. 1766-67. He acknowledged that if a FAS 114 procedure was important, he would have made sure it was documented in the memo. Tr. 825. Bennett acknowledged that the memo's accuracy was important. Tr. 503. Respondents conceded that they could have changed the memo if they felt it was inaccurate. Tr. 824-25, 1686, 1690-91.

In the memo, KPMG concluded that based on the procedures performed, TierOne's FAS 114 calculations appeared to be properly prepared and adequately supported at year-end 2008. Div. Ex. 120 at 5483. The memo documented the following procedures:

> (1) KPMG recalculated each FAS 114 calculation to ensure that reserves and charge-offs were accurately computed.
>
> (2) KPMG tied in appraisal values and other information to KPMG's test work in prior quarters; noted that the only change in many of the loans reviewed in prior quarters was the loan balance, primarily due to charge-offs or pay-down activity; and ensured appraisals were still current and other assumptions were appropriately adjusted for any new information.
>
> (3) KPMG selected a sample of FAS 114 loan calculations and obtained the original appraisals to ensure that the appraisal values used in the calculations were "as is" values and current (within the past twelve months); if the appraisals were not within the past twelve months, KPMG inquired whether a discount was applied to the appraised value and, if not, inquired why TierOne did not think a discount was necessary or appropriate.

[16] Burke prepared the memo, and Respondents reviewed and approved it. Tr. 502, 824-25, 1686.

> (4) Bennett and Burke attended a meeting with TierOne's special assets executive, David Frances (Frances), in early February 2009, to discuss a sample of the new FAS 114 calculations prepared during the fourth quarter and as of year-end "due to recent trends specifically associated with the loans."
>
> (5) KPMG leveraged from loan reviews performed throughout 2008 by the KPMG audit team, the FRM credit specialist, and TierOne's internal audit group, to get comfortable that the reserves calculated were accurate and risk ratings were appropriate on the selected loans.[17]

Id. at 5482.

The first procedure involved confirming that the FAS 114 calculations were properly tied to prior-period work or to various schedules related to the year-end financials. Tr. 503-04. The second procedure involved tracing TierOne's analysis to prior quarters and interim reviews. Tr. 504. Bennett acknowledged that even if KPMG reviewed a template prepared by management in a prior quarter, the auditors were assessing whether losses or reserves needed to be recorded at year-end. Tr. 504-05. As to prior-period work, the memo stated:

> Throughout the year, KPMG completed audit procedures on [TierOne]'s FAS 114 calculations. In order to effectively update these to year-end, we inquired of [TierOne] regarding any significant changes to the calculations and traced in amounts to prior periods as applicable. Per discussion with the client and after review of the updated FAS 114 calculations effective 12/31/08, it does not appear that significant changes were made. In addition, market conditions have not materially deteriorated since the time of our loan review procedures during the year and thus the year-end valuations appear reasonable.

Div. Ex. 120 at 5483 (emphasis added). At the hearing, Respondents could not explain the memo's statement about market conditions having not materially deteriorated; they admitted that the statement did not make sense given the market's continuing decline in 2008 and could not recall any specific rationale for the statement. Tr. 510-11, 838-40. Aesoph testified that he would have taken the statement out of the memo. Tr. 840.

Regarding the third procedure that involved appraisal review, the memo's definition of a "current" appraisal – "within the past twelve months" – was inconsistent with TierOne's stated policies and the 2008 economic climate. As Bennett was aware, TierOne's lending policy provided that an appraisal value may be valid for only a few months in a rapidly escalating or deteriorating market, which would apply to markets such as Nevada and Arizona. Tr. 379-81; Div. Ex. 213 at 106163. He was also aware of TierOne's representation in its ALLL Memo that,

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[17] The memo also contained TierOne's assumptions regarding estimated selling costs, number of months to sell, accrued interest, and interest rates that it applied to FAS 114 calculations; KPMG concluded that the assumptions appeared to be reasonable. Div. Ex. 120 at 5482-83.

as to Nevada land and residential construction loans, the bank tried to estimate collateral value declines in real estate by discounting appraised values older than six months.[18] Tr. 530-31; Div. Ex. 120 at 5449-50, 5458. Respondents agreed that updating an appraisal or obtaining a new appraisal may be prudent, for example, if economic conditions had changed or if there was evidence suggesting that the fair value should be reassessed. Tr. 374-75, 796. Aesoph conceded that an appraisal may become "stale" – that is, no longer indicative of the collateral's fair value – at less than a year old and appraised values might need to be adjusted based on the facts and circumstances of the individual loan, such as changes to the market where the collateral is located. Tr. 798-800. Bennett agreed that whether the fair value of a loan, based on an underlying appraisal, was reasonable at year-end had to be determined on a loan-by-loan basis. Tr. 501-02.

The fourth procedure involved one of the main meetings Bennett and Burke had with Frances, their "initial point of contact with management," after TierOne provided the templates to KPMG for review. Tr. 522. Regarding the fifth procedure that involved leveraging other work, eight loans that were ultimately found impaired at year-end were previously reviewed; seven by Washek and one by TierOne's internal audit group. Tr. 511-16, 833-35; Div. Ex. 120 at 5280, 5344, 5484. Washek's primary role was to assess the reasonableness of credit-risk ratings; she did not assess the fair value of the collateral or other assumptions underlying the FAS 114 loans. Tr. 516-18, 835-37. Rather, those procedures were the engagement team's responsibility. Tr. 518, 835.

c. FAS 114 Templates

In the work papers, TierOne's FAS 114 templates follow the memo. Div. Ex. 120 at 5484-5548. The templates are where the auditors reviewed TierOne's fair value estimates on a loan-by-loan basis, ticked and tied information, and documented relevant evidence relating to the FAS 114 loans. Tr. 498-500, 597, 689-90, 846-49, 1790-91. A "tick" mark is a letter, number, or other indication that the auditors performed a procedure.[19] Tr. 597; Div. Ex. 120 at 5485. The templates also contained the auditors' handwritten notes. Tr. 845-46. Of the forty-four templates for bucket one and two loans, the auditors noted "agreed to appraisal" or "agreed to a sample of the appraisals" on fifteen templates, which meant that that they reviewed the appraisal for reasonableness.[20] Tr. 695-97; see Div. Ex. 120 at 5501, 5503, 5506, 5512-14, 5516-20,

[18] As discussed infra, TierOne used appraisals older than six months without a discount for numerous loans.

[19] The tick marks indicated that the auditors tied figures to the prior year; "footed down" and "cross-footed" figures, meaning that they made sure that a template was calculated correctly both vertically down a column for the loan and horizontally across loan columns to arrive at the borrower's total position for the values on its loans; and recalculated the required ALLL. Tr. 845, 849-50; Div. Ex. 120 at 5485; see, e.g., id. at 5487.

[20] The auditors made other notations, such as whether discounts or reserves appeared reasonable based on "current information" or "market conditions," whether an appraisal was reviewed in a prior quarter, or whether Washek had conducted a review for credit risk. See, e.g., Div. Ex. 120 at 5486, 5489, 5491, 5497-98, 5508, 5523.

5530-31, 5533-34. The auditors did not note any exceptions as to TierOne's fair value estimates. Tr. 528, 896.

The fair value estimates for numerous bucket one and two loans were based on undiscounted appraisals from the first half of 2008 or earlier. See, e.g., Div. Ex. 120 at 5485-86, 5488, 5493, 5497, 5499, 5500, 5503, 5506-07, 5522-23, 5525-26, 5531-32. At the hearing, Bennett could not identify any loan-specific evidence or documented procedures to support the conclusion that TierOne's fair value estimates for bucket one loans based on undiscounted appraisals from the first half of 2008, as to five borrowers in Nevada and three borrowers in Arizona, were reasonable at year-end 2008.[21] Tr. 533, 539-40, 549-50, 554-58, 564-66, 573-74, 586-88, 591-98, 602; see Div. Ex. 120 at 5485, 5487-88, 5496, 5499, 5500, 5503, 5507; cf. id. at 5557-58, 5566-67. Rather, he testified about several undocumented procedures and considerations as informing his decisions. See, e.g., Tr. 536-40, 548-50, 556-57, 564-65, 587-93. Aesoph conceded that the templates for several Nevada loans cited no evidence supporting the conclusion that TierOne's fair value estimates, based on undiscounted appraisals from the first half of 2008, were reasonable at year-end. Tr. 867-73, 888-89. He testified that KPMG was not opining on any individual loan, but evaluating the ALLL on an overall basis. Tr. 866, 868, 873.

On the template for a borrower's bucket one Florida loans, the auditors noted that they ticked and tied calculations, TierOne did not think it was necessary to discount an October 2007 appraisal based on "current information," and KPMG recommended that management order a new appraisal in order to assess future reserves, if necessary. Div. Ex. 120 at 5497; Tr. 634-37. Bennett could not point to any loan-specific evidence or documented procedures to support the conclusion that TierOne's fair value estimate, based on the undiscounted October 2007 appraisal, was reasonable, but testified about his general understanding of Florida's market conditions and that charge-offs were recorded in prior quarters. Tr. 635-37. He acknowledged that Florida generally experienced significant real estate declines in 2008. Tr. 634.

Regarding a borrower's bucket one South Carolina loans, TierOne's fair value estimates were based on appraisals from 2005 and 2006, discounted for the fact that the underlying property was incomplete, but there was no noted discount for market deterioration. Div. Ex. 120 at 5285, 5498; Tr. 602-05. At the hearing, Bennett testified that the South Carolina real estate market was stable, based on representations in TierOne's ALLL Memo; however, in prior investigative testimony, he testified that there was a trend in the Carolinas of decreasing real estate values during 2008. Tr. 606-08. The ALLL Memo contained an excerpted article reporting a mix of positive and negative statements about the South Carolina market, but disclosed that South and North Carolina showed the most significant decline in total sales and sale prices based on market data providing median sales prices of existing single-family homes for metropolitan areas and total sales for single-family, apartment condos and co-ops during 2005 to 2008. Div. Ex. 120 at 5437, 5453-54; Tr. 606-08.

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[21] These borrowers represented approximately 30% of bucket one loans in terms of gross loan amount, and their fair value estimates totaled in the aggregate nearly $35 million. Div. Ex. 120 at 5485, 5487-88, 5496, 5499, 5500, 5503, 5507; see id. at 5484-5520.

E. Undocumented Procedures

At the hearing, Respondents testified about procedures and considerations not documented in the work papers.[22] In particular, Respondents testified to the following:

First, Respondents claimed that the engagement team obtained and reviewed loan files in evaluating the FAS 114 loans. Tr. 523-26, 1687, 1789-90. Bennett acknowledged that he could have documented that he reviewed loan files, and there are other work papers where the auditors documented such review. Tr. 523-26; see, e.g., Div. Ex. 120 at 5276. Although the FAS 114 procedures memo and templates indicate that the auditors reviewed appraisals and "current information" as to certain loans, those work papers do not reference any information from loan files to support the use of numerous undiscounted appraisals. Div. Ex. 120 at 5482-5548; Tr. 1789-91. The instances documented in the work papers in which the auditors reviewed materials from the loan files involved procedures unrelated to whether appraisals were current or valid at year-end. See, e.g., Div. Ex. 119 at 5004-08, 5081-85, 5089-93, 5108-11.

Second, Respondents claimed that FAS 157's standards on fair value measurements helped inform their conclusion that TierOne's estimates were reasonable.[23] Tr. 372, 537, 566, 616, 1767. It is Respondents' position that because the second half of 2008 involved an increase in foreclosures and distressed sales, market information that included such data was not determinative of fair value under FAS 157, and management represented that it viewed appraisals in the second half of 2008 as more indicative of foreclosures than fair value. Tr. 372, 381-82, 550-51, 569, 1772-78.

The weight of the evidence casts doubt on Respondents' contention that either their or management's proffered interpretation of FAS 157 – i.e., that appraisals and market information were less indicative of fair value due to increased distressed sales and/or foreclosures in 2008 – played any meaningful role in their assessment of TierOne's fair value estimates. There is no reference, in either the memo or templates, to FAS 157. Div. Ex. 120 at 5482-5548; Tr. 693. KPMG's FAS 157 work paper, which Bennett reviewed, does not reference FAS 114 or the ALLL in its inventory of significant accounts and disclosures accounted for under that standard. Tr. 551-54, 1767-70; Resp. Ex. 4 at 4027-30. TierOne's FAS 157 disclosure in its 2008 Form 10-K, which the auditors reviewed, neither indicated that TierOne considered appraisals less

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[22] For example, even though the memo does not indicate that the auditors inquired of management whether a discount was necessary or appropriate if the appraisal was within the past twelve months, Respondents testified that they inquired of management about appraisals that were less than twelve months old. Tr. 519-20, 827-30; Div. Ex. 120 at 5482. Bennett's manager review comments directed to audit staff indicate that he questioned certain undiscounted appraisals and why TierOne had not obtained updated appraisals, see Resp. Ex. 192 at 74557-58, but as discussed supra, the work papers lack documented rationale for TierOne's use of undiscounted appraisals for numerous loans.

[23] TierOne adopted FAS 157 in January 2008. Div. Ex. 130 at 127.

indicative of fair value at year-end 2008 nor discussed the impact of distressed sales or foreclosures in valuing collateral; to the contrary, the Form 10-K represented that in determining fair value of real estate collateral, TierOne relied on external appraisals and assessment of property values by internal staff. Div. Ex. 130 at 127-28, 130; Tr. 791-93, 1743. There is no evidence that TierOne adjusted, or that the auditors recommended adjusting, an appraisal because of concerns the appraisal did not reflect fair value; instead, TierOne continued to use appraisals to estimate fair value in 2008 through early 2009. Tr. 679-80, 789-90. During the audit, KPMG recommended that TierOne update appraisals to continue to value the loans. Tr. 379. In prior investigative testimony, Bennett stated that a current appraisal was the best indicator of fair value. Tr. 369-72. Notably, Respondents conceded that in reviewing market data to assess management's estimates, they did not consult indices that removed, nor performed any analysis to remove, distressed sales from the data. Tr. 348-50, 733-34, 738.

At the hearing, Aesoph pointed to a statement in the TierOne ALLL Memo about certain Nevada loans to support Respondents' contention about FAS 157. Tr. 1772-78. That statement read: "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." Div. Ex. 120 at 5450. But the very same paragraph in the ALLL Memo represented how TierOne would value collateral in this context: "The Bank tries to estimate collateral value declines in real estate by discounting appraised values, which are older than six months. The percentage of the discount is based on facts and circumstances specific to the area where the collateral is located." Id. It is undisputed that TierOne did not consistently follow this stated policy.

Third, Respondents claimed that in response to TierOne's failure to discount appraisals in accordance with the policy articulated in the ALLL Memo, they had a conversation with Kellogg, who explained to them that TierOne had charged-off and reserved for losses of approximately 30% in Nevada's impaired loan portfolio, and that based on market data, these recognized losses were consistent with the approximate 30% market decline in Nevada in 2008. Tr. 530-31, 535-37, 582-83, 1783-84. Bennett testified that the auditors corroborated Kellogg's representation by calculating the 30% loss recognition based on a schedule of delinquent Nevada loans attached to another work paper and by consulting market data. Tr. 583-84, 1605-10; Div. Ex. 120 at 5574, 5590-91; Resp. Ex. 68 at 55, 57-59.[24] In assessing TierOne's FAS 114 portfolio, Respondents considered Kellogg's representation and their corroboration of it to be important to their conclusion on overall charge-offs and the ALLL, and Aesoph testified that it further corroborated their test work. Tr. 580-81, 585, 1693-95, 1783-87.

Respondents' conversation with Kellogg and their related procedures as to the 30% loss recognition are not documented in the work papers. Tr. 579-80, 584, 633-34, 692, 1695-97, 1787-88. In any event, their finding of a 30% consistency between total recognized losses and overall market decline in 2008 for Nevada loans failed to sufficiently corroborate management's

[24] Resp. Ex. 68 is the ALLL Memo with attached data, including market information and statistics. Citations are to the handwritten page numbers in the bottom right corner of the exhibit.

representation. TierOne's recognized losses were significantly less in the second half of the year compared to the first half of the year, even though market conditions especially in Nevada were worse in the second half of the year, and losses recognized in 2008 did not necessarily relate to collateral value deterioration in that year. Div. Ex. 120 at 5432; Resp. Ex. 68 at 54-55, 57-59, 62, 167; Tr. 859, 875-77, 931.

F. <u>Subsequent Appraisals</u>

Subsequent to the March 2009 audit opinion, Respondents learned of new appraisals affecting FAS 114 loans during their interim review of TierOne's financial statements. In its Q1 2009 FAS 114 templates, TierOne disclosed a January 2009 appraisal pertaining to one Nevada loan that was valued at year-end 2008 with a discounted, older appraisal, and a February 2009 appraisal pertaining to another Nevada loan that was valued at year-end 2008 with an undiscounted April 2008 appraisal; each appraisal showed a $2 million decline in value from the estimate used at year-end 2008. Tr. 672-75; Div. Ex. 120 at 5499, 5504, 5557; Div. Ex. 123 at 8155-56. For one loan, that was a 29% decline in its estimated collateral value per appraisal from year-end 2008 and for the other loan, a 40% decline. Div. Ex. 120 at 5499, 5504; Div. Ex. 123 at 8155-56. In Q1 2009, the auditors noted that these new appraisals resulted in material provisions, as TierOne recognized $1.8 million in new provisions for each of these two loans. Div. Ex. 123 at 8092-93; Tr. 674-75. These new appraisals resulted in a net impact to the ALLL of $3.6 million and exceeded the $1.9 million materiality threshold set by KPMG during the 2008 audit.[25] Tr. 924, 1704-05.

As reflected in an April 2009 work paper reviewed by Respondents, TierOne made adjustments in Q1 2009 based on these new appraisals. Div. Ex. 123 at 8090, 8092-94; Tr. 1664-65. However, Aesoph conceded that KPMG did not evaluate either loan under AU § 561, the auditing standard for subsequent discovery of facts existing at the date of the auditor's report, even though these appraisals existed before KPMG's audit opinion. Tr. 921, 924. Bennett did not recall having a discussion with anyone at TierOne about whether the losses from these appraisals should have been recorded at year-end 2008. Tr. 675-76, 678. He testified that he did not believe AU § 561 was triggered, but that he considered the amount of those adjustments in relation to the information in TierOne's year-end financial statements and that management was continuing to record adjustments. Tr. 1666-67.

G. <u>Expert Testimony</u>[26]

Anjan V. Thakor (Thakor), Ph.D., testified for the Division as an expert in finance and economic analysis. Tr. 107-08, 111-12; <u>see</u> Div. Ex. 191. Generally, he opined that many of the

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[25] To put these figures in further context: at year-end 2008, TierOne reported net interest income after provisions of $2.9 million, provisions of $84 million, and a loss before income taxes of $93 million. Div. Ex. 130 at 55.

[26] To the extent that the experts' evidence does not lead to findings of fact, it will be summarized here and referred to as appropriate in the Conclusions of Law section of this Initial Decision.

appraisals used to value the collateral underlying TierOne's FAS 114 loans were stale as of year-end 2008, and that TierOne's recorded collateral values were inconsistent with the sharp declines in real estate values that year, particularly in the second half of 2008, based on publicly available pricing indices. Div. Ex. 191 at 11-13, 35-38, 231; Tr. 113-15, 118-20, 145. To reach this conclusion, he recalculated TierOne's FAS 114 calculations in several LPO States by adjusting appraised values used by TierOne, based on the 2008 mean price decline across real estate pricing indices in the geographic area where the collateral securing the loan was located. Div. Ex. 191 at 64-65, 106, 130, 148, 162-63, 182-85, 239-41; Tr. 159-66. He further opined that this appraisal staleness problem was particularly acute for FAS 114 loans with underlying collateral in Nevada and Arizona, and that for collateral in those states, even appraisals from the first half of 2008 were often stale and overstated property values by year-end. Div. Ex. 191 at 11-17, 231; Tr. 151-52, 179, 186-88.

John Barron, CPA, testified for the Division as an expert in accounting and auditing standards. Tr. 1005-07; see Div. Ex. 211. He opined that Respondents violated a number of PCAOB auditing standards and that their failure to exercise due professional care over the FAS 114 portion of the ALLL, which was individually material and high risk, meant that they failed to exercise due professional care with respect to the audit as a whole. Div. Ex. 211 at 9-12, 34; Tr. 1016, 2239.

Christopher M. James, Ph.D., testified for Respondents as an expert in economic analysis. Tr. 1814-15; see Resp. Ex. 43A. He opined that Thakor's report was flawed because it relied on real estate pricing indices that included distressed sales at a time when there was an increase in price volatility combined with a substantial share of distressed sales in many of TierOne's loan markets. Resp. Ex. 43A at 2-3; Tr. 1825-28, 1847-48. He further opined that during the 2008 and 2009 financial crisis, appraisals were less reliable and less representative of fair values. Resp. Ex. 43A at 4; Tr. 1903-04.

Sandra Johnigan, CPA/CFF, CFE, testified for Respondents as an expert in accounting and auditing standards. Tr. 1917; see Resp. Ex. 42. She opined that Respondents complied with PCAOB auditing standards and that the engagement team obtained sufficient competent evidential matter to afford a reasonable basis for the audit opinion. Resp. Ex. 42 at 15-16. She further opined that distressed sales are excluded from the definition of fair value in FAS 157 and that use of pricing indices that include distressed sales would be inconsistent with that standard. Resp. Ex. 42 at 11; Tr. 1985-88.

H. Missing Witness

Respondents urge that an adverse inference be drawn from the fact that the Division did not call Kellogg to testify at the hearing but has attempted to cast doubt on whether Respondents' conversation with him about the 30% loss recognition took place. Specifically, they argue that the Division elected not to call Kellogg despite having a cooperation agreement with him, which they contend would have required him to testify if the Division called him, and an inference should be drawn that, if called, Kellogg would have corroborated Respondents' testimony.

The undersigned has not drawn any inference adverse to the Division's case, or to Respondents', from the absence of Kellogg. He was not unavailable to Respondents as a witness. See United States v. Cole, 380 F.3d 422, 427 (8th Cir. 2004). Although the cooperation agreement required Kellogg to testify fully and truthfully when requested to testify by the Division in connection with other proceedings, it was not "peculiarly" within the Division's control to call him. Id.; see United States v. Eberhart, 467 F.3d 659, 665 (7th Cir. 2006); United States v. Williams, 113 F.3d 243, 246 (D.C. Cir. 1997); Resp. Ex. 232. Respondents could have subpoenaed him pursuant to Commission Rule of Practice 232, 17 C.F.R. § 201.232. When a party calls a hostile witness or a witness identified with an adverse party, interrogation may be by leading questions. See generally Fed. R. Evid. 611(c); 1 McCormick on Evidence § 6, at 23-25 (Kenneth S. Broun ed., 6th ed. 2006).

III. CONCLUSIONS OF LAW

Respondents are charged, pursuant to Exchange Act Section 4C, 15 U.S.C. § 78d-3, and Rule 102(e)(1)(ii), 17 C.F.R. § 201.102(e)(1)(ii), with improper professional conduct.[27] The charges are based on their alleged improper practices related to TierOne's ALLL account in the year-end 2008 audit. The Division argues that negligent conduct by Respondents violated PCAOB auditing standards and constituted a single instance of highly unreasonable conduct as well as repeated instances of unreasonable conduct. Respondents contend that their audit was within professional standards. In this section, it is concluded that their conduct violated PCAOB auditing standards and constituted a single instance of highly unreasonable conduct; alternatively, their conduct constituted repeated instances of unreasonable conduct.

A. Rule 102(e)(1)(ii)

Rule 102(e)(1)(ii) provides for sanctions against accountants who "have engaged in . . . improper professional conduct."

[27] Exchange Act Section 4C, which was added by the Public Company Accounting Reform and Investor Protection Act of 2002, also known as the Sarbanes-Oxley Act, codified Rule 102(e), which had been in existence for many years, and provided specific statutory authority for its provisions. See Pub. L. No. 107-204, § 602, 116 Stat. 745, 794 (2002). Because of this history and the precedent concerning Rule 102(e), the discussion herein will cite Rule 102(e) rather than the nearly identical provisions of Exchange Act Section 4C. "It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress." CFTC v. Schor, 478 U.S. 833, 846 (1986) (internal quotation marks omitted); see Lorillard v. Pons, 434 U.S. 575, 580-81 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change . . . [and] where, as here, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute." (internal citations omitted)).

> With respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:
>
> (A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
>
> (B) Either of the following two types of negligent conduct:
>
> (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
>
> (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

17 C.F.R. § 201.102(e)(1)(iv).

This case involves alleged negligent conduct; the Division does not allege intentional or reckless conduct.

1. Highly Unreasonable Conduct

"Highly unreasonable" was first defined in the Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164 (Oct. 26, 1998) (Rule 102(e) Amendment), as a new concept. It is higher than ordinary negligence but lower than recklessness. Rule 102(e) Amendment, 63 Fed. Reg. at 57167. It is measured by the degree of departure from professional standards and not the intent of the accountant. Id. It is not judged by hindsight, but compares actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken. Id. at 57168. A single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and may not pose a future threat to the Commission's processes requiring Commission action. Id. at 57166 & n.28, 57167. However, a single instance of highly unreasonable conduct when an accountant knows, or should know, that heightened scrutiny is warranted conclusively demonstrates a lack of competence to practice before the Commission. Id. at 57164, 57166.

2. Repeated Instances of Unreasonable Conduct

"Unreasonable" connotes an ordinary negligence standard. Rule 102(e) Amendment, 63 Fed. Reg. at 57169. "'[R]epeated' may encompass as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits . . . [such as] fail[ure] to gather evidential matter for more than two accounts, or certific[ation of] accounting inconsistent with GAAP in more than two accounts."[28]

[28] Rule 102(e) looks to the number of instances of unreasonable conduct, not the number of accounts; there is no requirement that the two instances pertain to different accounts in an audit. Kevin Hall, CPA, 97 SEC Docket at 23691.

Id. "[Since] 'repeated instances' may not always demonstrate a lack of competence to practice before the Commission . . . this subparagraph requires . . . a specific finding that the conduct indicates a lack of competence." Id. "The finding is based on an evaluation of the conduct itself and does not require a separate evidentiary basis." Id. "More than one violation of applicable professional standards ordinarily will indicate a lack of competence." Id.

3. Applicable Professional Standards

An auditor does not guarantee that financial statements are free of material misstatement. His or her "responsibility [is] to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." AU § 110.02. During the time at issue, applicable professional standards included GAAP, PCAOB auditing standards, including GAAS, the AICPA Code of Professional Conduct, and Commission regulations.[29] Rule 102(e) Amendment, 63 Fed. Reg. at 57166.

Respondents' conduct must be compared with actions a reasonable accountant would have taken at the time of the audit, without the benefit of hindsight, and evaluated in light of standards in effect at the time of the conduct at issue, which here is October 2008 to March 2009 for the audit and April 2009 for the subsequent discovery of facts.[30] See Kevin Hall, CPA, 97 SEC Docket at 23689-90 & n.25; Rule 102(e) Amendment, 63 Fed. Reg. at 57168. Under the third general standard, "[d]ue professional care is to be exercised in the performance of the audit and the preparation of the report." AU § 150.02. "Due professional care requires the auditor to exercise professional skepticism," i.e., "an attitude that includes a questioning mind and a critical assessment of audit evidence." AU § 230.07. "When the audit presents a risk of material

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[29] The ten basic GAAS standards are listed in AU § 150.02, and detailed interpretations follow. Those at issue in this proceeding are: the third general standard (Due Professional Care) and AU § 230 (Due Professional Care); the third standard of field work (Sufficient Competent Evidential Matter) and AU §§ 312 (Audit Risk and Materiality), 316 (Consideration of Fraud in a Financial Statement Audit), 319 (Consideration of Internal Control in a Financial Statement Audit), 326 (Evidential Matter), 328 (Auditing Fair Value Measurements and Disclosures), 333 (Management Representations), and 342 (Auditing Accounting Estimates); and 561 (Subsequent Discovery of Facts Existing at the Date of the Auditor's Report). Also at issue are AS Nos. 3 (Audit Documentation) and 5 (Audits of Internal Control Over Financial Reporting).

[30] AU §§ 312, 319, and 326, which were in effect for the audit at issue in this proceeding, were superseded by PCAOB ASs for audits for fiscal years beginning on or after December 15, 2010. PCAOB; Order Approving Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards, 75 Fed. Reg. 82417 (Dec. 30, 2010), approving rules as proposed, 75 Fed. Reg. 59332 (Sept. 27, 2010); PCAOB Release No. 2010-004, Aug. 5, 2010, at A9-3, A9-12, A9-13, A10-8 n.11.

misstatement or fraud, auditors must increase their professional care and skepticism."[31] Kevin Hall, CPA, 97 SEC Docket at 23690 (citing AU §§ 312.17, 316.27).

Under the third standard of field work in effect at the time of the 2008 audit, "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 150.02; accord AU § 326.01, .22. "To be competent, evidence, regardless of its form, must be both valid and relevant." AU § 326.21. Among the presumptions about the validity of evidential matter, greater weight is attached to evidence "obtained from independent sources outside an entity . . . than that secured solely within the entity," and to the "independent auditor's direct personal knowledge . . . than information obtained indirectly." Id. "The independent auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation." AU § 326.25. "[R]epresentations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 333.02; see S.W. Hatfield, CPA, Exchange Act Release No. 69930, 2013 SEC LEXIS 1954, at *6 (July 3, 2013).

PCAOB standards also require that auditors "must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions," and such "[a]udit documentation must clearly demonstrate that the work was in fact performed." AS No. 3 ¶ 6. "Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement[,] . . . [t]o understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached[.]" Id.; see Kevin Hall, CPA, 97 SEC Docket at 23693 ("with no provision for recourse to external sources"). "In determining the nature and extent of the documentation for a financial statement assertion, the auditor should consider," among other factors, the "[r]isk of material misstatement associated with the assertion," and "[e]xtent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation[.]" AS No. 3 ¶ 7. "[I]f audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done." AS No. 3, App. A ¶ A10; see id. ¶ A26 ("Auditors have an unconditional requirement to document their work.").

[31] The terms set forth in the PCAOB standards describe the degree of responsibility that the standards impose on auditors: (1) the words "must," "shall," and "is required" indicate unconditional responsibilities; (2) the word "should" indicates responsibilities that are presumptively mandatory, and the auditor must comply with requirements of this type unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard; and (3) the words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. PCAOB Rule 3101.

Thus, to conclude that Respondents engaged in improper professional conduct within the meaning of Rule 102(e), it is necessary to conclude, first, that they violated auditing standards and, second, that the violation[s] resulted from highly unreasonable conduct or repeated instances of unreasonable conduct by them. An auditing standard violation in itself is not improper professional conduct within the meaning of Rule 102(e).

B. Respondents Violated PCAOB Auditing Standards and Engaged in Improper Professional Conduct within the Meaning of Rule 102(e)

The ALLL was one of TierOne's most critical accounts and reflected its financial condition. In particular, the FAS 114 portion of the ALLL was individually material to the audit and had a significant risk of material misstatement. Quantitatively, TierOne had $185.9 million in impaired loans and $16.4 million in reserves for impaired loans at year-end 2008, both figures greater than KPMG's $1.9 million materiality threshold for the audit. Qualitatively, the FAS 114 portion was a significant estimate because of the risk related to collateral valuation, which in turn affected how much TierOne would expect to recover on its impaired loans, as loan repayment for FAS 114 loans was expected to be provided solely by the underlying collateral. Further, if TierOne recorded more loan losses, its OTS-mandated capital ratios would decrease, which would put TierOne in danger of violating OTS requirements and result in enforcement action. Also, its reported net interest income after provisions was $2.9 million at year-end; a small increase in losses could have changed that figure into a loss.

Moreover, the ALLL had a high risk of error and fraud. Collateral overvaluation and the use of stale appraisals was a specific, identified risk point. Such risks were underscored by TierOne's loan portfolio problems, management oversight, and other red flags as set forth in the OTS report and known by Respondents; the real estate market collapse in LPO States with a significant portion of impaired loans; and TierOne's weak financial condition which, as Respondents were aware, increased pressure on management to understate losses. Given the convergence of risk and materiality in this area of the audit, there was heightened importance for Respondents to exercise professional skepticism, corroborate management representations, and perform extensive audit procedures and obtain persuasive evidence to support their audit judgments. See Kevin Hall, CPA, 97 SEC Docket at 23690; AU §§ 230.07, 312.12, .16, .17, 316.13, .27, .46, .52, .54.

1. Internal Control Over Financial Reporting

a. Standards

For year-end 2008, Respondents performed an integrated audit of TierOne, that is, they evaluated its internal control over financial reporting together with its financial statements. AS No. 5 ¶¶ 1, 6. "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting." AS No. 5 ¶ 3. "Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of" the reporting date.[32] Id. (internal footnote omitted).

In an integrated audit, the auditor should design tests of controls to obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting and control risk assessments for the purposes of the audit of the financial statements. AS No. 5 ¶ 7. "Risk assessment underlies the entire audit process . . . , including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control." AS No. 5 ¶ 10. "The auditor should focus more of his or her attention on the areas of highest risk" and "should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud," taking into consideration controls that might address these risks, including "[c]ontrols related to significant management estimates[.]" AS No. 5 ¶¶ 11, 14.

"As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated." AS No. 5 ¶ 30. For example, "[t]he auditor might determine the likely sources of potential misstatements by asking himself or herself 'what could go wrong?' within a given significant account or disclosure." Id. "To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should," among other objectives, "[v]erify that the auditor has identified the points within the company's processes at which a misstatement — including a misstatement due to fraud — could arise that, individually or in combination with other misstatements, would be material"; and "[i]dentify the controls that management has implemented to address these potential misstatements[.]" AS No. 5 ¶ 34.

Based on such assessments, "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion," and should test those controls for design and operating effectiveness. AS No. 5 ¶¶ 39-45. "As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases." AS No. 5 ¶ 46. This is because "the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control"; rather, as "the auditor's objective is to express an opinion on the company's internal control over financial reporting overall[,] [t]his allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control." Id., Note. "Some types of tests, by their nature, produce greater evidence of the effectiveness of controls

[32] "A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." AS No. 5, App. A ¶ A7 (emphasis omitted). There is a "reasonable possibility of an event" when the likelihood of the event is "probable," meaning that the future event is likely to occur; or "reasonably possible," meaning that the chance of the future event occurring is more than remote but less than likely. Id.; FAS 5 ¶ 3.

than other tests." AS No. 5 ¶ 50. "Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control." Id., Note. "If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement," which is not the case here. AS No. 5 ¶ 90.

b. Analysis

The auditors identified the risk of the ALLL being improperly calculated or monitored, or inadequate, as a risk at the financial statement level that could result in a material misstatement or material weakness. The ALLL had an identified high inherent risk of error and an identified risk of fraud. KPMG identified collateral overvaluation as a specific risk point associated with the reserve estimates for FAS 114 loans. The OTS report exposed flaws in TierOne's valuation methodology and problems with its loan practices, finding among other deficiencies that the bank had collateral-dependent loans with no appraisal, unsupported appraisals, and stale appraisals. Collateral values drove losses on FAS 114 loans.

In testing TierOne's internal controls, the auditors identified Control Lot 7-2, Appraisal Review, as related to the risk of collateral overvaluation. However, that control did not address the risk associated with the reliability or validity of appraisals in valuing collateral for FAS 114 loans at year-end. The purpose of the control was to assess whether TierOne obtained and reviewed appraisals when loans were originated. As to other ALLL-related controls, there is no evidence that those controls sufficiently addressed the risk of collateral overvaluation at year-end either. The high-level reviews performed by management and the ACC, and tested by the auditors, do not reveal that an internal control meaningfully or specifically addressed this risk. Given the risks of error and fraud and that the FAS 114 portion of the ALLL was a significant estimate, the failure to obtain competent, persuasive evidence related to whether TierOne's internal controls addressed the risk of collateral overvaluation fell short of the professional standards described.

Moreover, the absence of a sufficient control addressing collateral overvaluation should have been treated as an indication of material weakness in TierOne's internal control over financial reporting. AS No. 5 ¶¶ 2-3, 90. There was a reasonable possibility that as a result of collateral overvaluation on FAS 114 loans, material misstatements regarding TierOne's reserve estimates and other financial statement assertions affected by recognized losses on FAS 114 loans would not be timely prevented or detected. AS No. 5, App. A ¶ A7. Due to the failure to identify or test a control that sufficiently addressed the prevention or detection of a material misstatement caused by collateral overvaluation on FAS 114 loans, Respondents did not have a reasonable basis to conclude that no material weaknesses existed and issue an unqualified opinion regarding the effectiveness of TierOne's internal control over financial reporting. In conclusion, Respondents did not comply with AS No. 5.

3. Evaluation of FAS 114 Portion of the ALLL

a. Standards

Although management is responsible for making the fair value measurements and disclosures included in the financial statements, "[t]he auditor should obtain sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP."[33] AU § 328.03, .04. "Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures," which may involve "testing management's significant assumptions, the valuation model, and the underlying data." AU § 328.23; see AU § 328.09 ("The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach."), .13 (based on the risk of material misstatement, "the auditor determines the nature, timing, and extent of the audit procedures").

"When there are no observable market prices and the entity estimates fair value using a valuation method, the auditor should evaluate whether the entity's method of measurement is appropriate in the circumstances," which "involves obtaining an understanding of management's rationale for selecting a particular method," as well as consideration whether, among other factors, "[t]he valuation method is appropriate in relation to the business, industry, and environment in which the entity operates." AU § 328.18. "The auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently . . . ." AU § 328.19. When management's estimate is based on a valuation, such as an appraisal, that does not coincide with the financial reporting date, "the auditor obtains evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date." AU § 328.25. When testing the entity's fair value measurements, the auditor evaluates whether (a) management's assumptions are reasonable and reflect, or are not inconsistent with, market information; (b) the

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[33] The standards further provide:

> GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.

AU § 328.03.

fair value measurement was determined using an appropriate model, if applicable; and (c) management used relevant information that was reasonably available at the time. AU § 328.26; accord AU § 328.29 ("Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information."), .36 ("To be reasonable, the assumptions on which the fair value measurements are based . . . need to be realistic and consistent with . . . [t]he general economic environment, the economic environment of the specific industry, and the entity's economic circumstances; [and] [e]xisting market information[.]").

Similarly, "[t]he auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole." AU § 342.04. "[W]hen planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors" used by management in its estimation process, even if that process "involves competent personnel using relevant and reliable data," given the "potential for bias in the subjective factors." Id. The auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that (a) all accounting estimates that could be material to the financial statements have been developed; (b) those accounting estimates are reasonable in the circumstances; and (c) the accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed. AU § 342.07.

"In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate." AU § 342.10. Based on that understanding, the auditor should use one or a combination of approaches specified under the auditing standard; here, the auditors "[r]eview[ed] and test[ed] the process used by management to develop the estimate." AU § 342.10(a). In reviewing and testing management's process, the auditor may consider performing a number of procedures, examples include: identifying the sources of data and factors that management used in forming the assumptions, and considering whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests; evaluating whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data; and considering whether changes in the business or industry may cause other factors to become significant to the assumptions. AU § 342.11.

b. Analysis

As documented in the work papers, the auditors reviewed the templates prepared by TierOne. The templates contained management's fair value collateral estimates per appraisal for the FAS 114 loans and reserve estimate calculations, the latter of which were directly affected by management's collateral valuation decisions. Numerous impaired loans in LPO States were valued at year-end 2008 using older or undiscounted appraisals from the first half of 2008 or earlier, despite continued market declines in the second half of 2008 in several of those geographic markets. Respondents were fully aware of these market conditions as well as the risks associated with collateral valuation and red flags pertaining to TierOne's loan portfolio.

Yet, the rationale for TierOne's decisions not to apply discounts for such loans is largely undocumented, and the auditors' procedures to address this issue are not evident from the work papers. At the hearing, when confronted with the undiscounted appraised values that TierOne used for numerous loans, Respondents could not point to loan-specific evidence or documented procedures to support TierOne's decision to not discount such appraisals in the wake of deteriorating market conditions.[34] See Wendy McNeely, CPA, Exchange Act Release No. 68431 (Dec. 13, 2012), 105 SEC Docket 61684, 61699-61700 (the absence of work papers on a claimed procedure is evidence that the audit team did not devote substantial, if any, effort to review the area in question); Gregory M. Dearlove, CPA, Exchange Act Release No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1883 n.39 ("[W]orkpapers are ordinarily the foundation on which support for audit conclusions is demonstrated."), pet. denied, 573 F.3d 801 (D.C. Cir. 2009); Russell Ponce, 54 S.E.C. 804, 821 (2000) ("[D]ue care is not exercised if the auditor fails to corroborate representations of client management that are significant to the financial statements[.]" (internal quotation marks omitted)), pet. denied, 345 F.3d 722 (9th Cir. 2003).

Moreover, the description of the audit work in the FAS 114 procedures memo shows that Respondents did not sufficiently assess TierOne's collateral valuation decisions and the impact of those decisions on reserve estimates. The memo stated that the auditors considered appraisals "current" if they were within the past twelve months as of year-end 2008, and that they inquired about management's discount decisions if appraisals were not within the last twelve months. The assumption that appraisals were current if they were within the past twelve months was inconsistent with market information and TierOne's representations. Further, in assessing prior-period test work, the memo stated that there was no material market deterioration at year-end compared to prior quarters – a statement that Respondents could not explain and Aesoph disavowed. At the hearing, Respondents distanced themselves from the memo, pointing to undocumented considerations and procedures, which underscores the deficiency of the procedures as documented.

Respondents' procedures in evaluating TierOne's FAS 114 estimates fell short of professional standards. As discussed above, they failed to obtain sufficient competent evidence to support their audit judgments regarding TierOne's estimates, and the work papers do not reflect the due care and professional skepticism required of this high risk and material area of the audit. Respondents' work in other areas of the audit, albeit to the highest professional standards, cannot save their deficient work over the FAS 114 portion of the ALLL, which was individually material. See Gregory M. Dearlove, CPA, 92 SEC Docket at 1912 ("Evidence that [the respondent] spent substantial time and effort on some auditing areas does not insulate him from liability for his failure to spend enough time and effort on others that were so material to [the company]'s financial statements."). In the context of the financial statements taken as a whole, the FAS 114 portion was critical to those statements and required heightened scrutiny. See Rule 102(e) Amendment, 63 Fed. Reg. at 57168 ("heightened scrutiny" warranted when matters are important or material, or when warning signals or other factors should alert an accountant of a

[34] Contrary to Respondents' assertion, this case does not come down to a mere handful of loans; the undiscounted loans subject to questioning at the hearing represent a significant portion of impaired loans, particularly in bucket one.

heightened risk, or as set forth in applicable professional standards). Respondents' failure to perform sufficient audit procedures with respect to, and obtain persuasive evidence supporting, management's estimates meant that they did not have a reasonable basis for their audit judgments.

c. Defenses

Respondents contend that they reviewed loan files in connection with the FAS 114 loans. However, the work papers do not reveal, and Respondents fail to point to, any information in those files that supports the conclusion that TierOne's use of numerous undiscounted appraisals from the first half of 2008 or earlier was reasonable at year-end 2008.

Respondents also contend that their understanding of FAS 157 informed their conclusion that management's estimates were reasonable.[35] Specifically, they assert that because the 2008 real estate market in general, and that of Nevada in particular, involved a large share of distressed sales and foreclosures, pricing indices that included such transactions were not indicative of fair value and management relied on its own assumptions in determining fair value.

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[35] FAS 157 provides:

> A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

FAS 157 ¶ 7 (Resp. Ex. 45). The Commission's Office of the Chief Accountant and Financial Accounting Standards Board issued a clarification in September 2008:

> The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

Press Release No. 2008-234, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008) (Resp. Ex. 66 at 2).

The record belies Respondents' assertion that, in evaluating TierOne's FAS 114 estimates, they conducted any sort of review consistent with their proffered interpretation of FAS 157. Moreover, FAS 157 does not explain the lack of sufficient evidence obtained and due care exercised in the audit work. See Wendy McNeely, CPA, 105 SEC Docket at 61697-98 & n.26 (rejecting after-the-fact rationalization unsupported by the evidence and that failed to explain the lack of due care). Although an orderly transaction is not a distressed or forced liquidation sale, FAS 157 does not suggest that market conditions should be ignored, and it is undisputed that auditing standards required Respondents to consider whether TierOne's estimates were consistent with market information and other available data. AU §§ 328.26, .29, .36, 342.11. The undersigned does not hold Respondents responsible for including or excluding disorderly sales in their review of market information; rather, their claimed review of market data should have indicated that management's estimates on numerous loans lacked reasonable support and prompted further inquiry and investigation.

To the extent TierOne stated in the ALLL Memo that it believed "current 'non-liquidation appraisals' [were] more indicative of liquidation appraisals" with regard to Nevada land and residential construction loans, management represented that it tried to estimate collateral value declines in real estate by discounting appraisals older than six months. However, management did not consistently follow that policy. See AU § 333.04 ("If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made."). Respondents point to a conversation with Kellogg and purported corroboration procedures they performed to explain why they considered management's failure to discount appraisals reasonable, claiming that TierOne's recognized 30% losses in Nevada were consistent with Nevada's 30% overall market decline in 2008. Aside from the fact that these claimed procedures are undocumented, neither Kellogg's representation nor Respondents' purported corroboration amount to sufficient evidence. TierOne's recognized losses were heavily weighted to the first half of 2008 and no further losses were recognized on many Nevada loans for the second half of the year, even though the real estate market in the second half of 2008 continued to decline. Further, collateral deterioration associated with recognized losses in 2008 did not necessarily pertain to market declines in that year alone.[36] The fact that the amount, if any, of prior-year collateral decline recognized as losses in 2008 is unproven does not obviate Respondents' failure to obtain sufficient evidence supporting the significance of their purported 30% consistency finding in this high risk and material area of the audit.

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[36] For similar reasons, TierOne's prior-period charge-offs fail to justify why no further losses were recognized in the second half of 2008 as to numerous loans. Respondents contend that it is unremarkable that the level of losses was higher in the first half of 2008 compared to the second half of the year because OTS required TierOne to charge off losses on impaired loans that had been provisioned, as opposed to maintaining those reserves in the ALLL. But the fact that TierOne engaged in charge-offs earlier in the year at OTS's direction fails to explain why it recognized no further losses on numerous loans in LPO States for the second half of the year, despite continued market declines in several of those geographic markets.

Lastly, Respondents assert that TierOne management deceived them with false representations and failed to disclose information relating to its impaired loans, as alleged by the Commission in separate federal court proceedings. But fraud and deception did not relieve Respondents of their responsibility to perform the audit in accordance with professional standards. See S.W. Hatfield, CPA, 2013 SEC LEXIS 1954, at *87; Michael S. Hope, CPA, 49 S.E.C. 568, 606 (1986); Touche Ross & Co., 45 S.E.C. 469, 469 (1974).

4. Subsequent Discovery of Facts

a. Standards

Auditing standards describe procedures that "should be followed by the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts." AU § 561.01. Specifically,

> [w]hen the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report.

AU § 561.04. "In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate . . . ." Id.

The auditor should take action in accordance with the procedures set out in AU § 561 if the nature and effect of the matter are such that "(a) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements," and "(b) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information." AU § 561.05. "With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued." Id. If an auditor determines that the subsequently learned facts would have affected his report, the auditor should then take action to prevent further reliance on his report. AU § 561.06. "These steps depend on the circumstances, but may include the issuance of revised financial statements and a revised auditor's report to ensure that those relying on the financial statements are notified of the effects of the subsequently discovered facts." S.W. Hatfield, CPA, 2013 SEC LEXIS 1954, at *27-28 (citing AU § 561.06).

b. Analysis

Respondents learned, shortly after the issuance of their March 2009 audit report, of the existence of new appraisals from January and February 2009 affecting FAS 114 loans with underlying collateral in Nevada. The new appraisals resulted in $1.8 million in new provisions for each loan, totaling $3.6 million in recognized losses in first-quarter 2009. The percentage decline in collateral value per appraisal was significant for each loan. At year-end 2008, one loan had been valued using an older appraisal and the other loan had been valued using an undiscounted appraisal from April 2008, despite continued market declines in the second half of the year. Thus, at least a portion of the losses recognized in early 2009 would have been the result of collateral deterioration experienced in 2008 and thereby related to TierOne's year-end 2008 financial statements. The information was of such a nature and from such a source that the auditors would have investigated it had it come to their attention during the course of the audit, but was unknown at the time, and the information was reliable and the facts existed at the date of the audit report. See AU § 561.04. Respondents, however, had no discussion with management, at any level, regarding whether additional losses should be recorded in 2008. See id.

Respondents argue that AU § 561 was not triggered because the new appraisals would not have affected their audit report given the $84 million in provisions and $93 million pretax loss recognized at year-end 2008, that TierOne was continuing to record adjustments in Q1 2009, and that a Nebraska loan had an over $1 million increase in collateral value in early 2009 from the estimate used at year-end 2008. But the new appraisals put into question the reliability of the financial statement assertions relating to the FAS 114 portion of the ALLL. Under the circumstances of this case and given the risk of collateral overvaluation, the new appraisals cast doubt on the collateral values that TierOne used at year-end 2008, given that numerous loans, particularly in Nevada, were also valued using older or undiscounted appraisals from the first half of 2008 or earlier, despite contrary market information. Cf. Staff Accounting Bulletin No. 99 (SAB No. 99), 64 Fed. Reg. 45150, 45151-52 (Aug. 19, 1999) ("[T]he auditor must consider both 'quantitative' and 'qualitative' factors in assessing an item's materiality. . . . [A]uditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole."). Also, among the issues Respondents could have considered, but did not, was whether additional provisions due to collateral value deterioration associated with the loans affected by the new appraisals, if recorded in 2008, would have significantly reduced TierOne's reported net interest income after provisions of $2.9 million or turned that figure into a loss. See AU § 561.05; SAB No. 99, 64 Fed. Reg. at 45152 ("Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are . . . [w]hether the misstatement changes a loss into income or vice versa.").

Moreover, Respondents failed to adequately consider whether investors relying on TierOne's financial statements would attach importance to the new facts. For example, one consideration is whether a footnote to those statements disclosing that new appraisals showed significant collateral value declines and resulted in material provisions in Q1 2009 would have raised concerns to a reasonable investor about the reliability of the financial statement assertions related to management's reserve estimates and loan losses, which in turn were critically reflective of TierOne's financial condition. Under AU § 561, Respondents should have conducted further inquiry and investigation to appropriately determine whether the new appraisals would have affected their report and the importance investors would have attached to the information before concluding that no additional steps were required.[37]

[37] To the extent the Division does not propose findings of fact or conclusions of law in support of other allegations in the OIP, those charges are deemed abandoned.

5. Respondents Engaged in Improper Professional Conduct within the Meaning of Rule 102(e)

In sum, Respondents' course of conduct related to the audit, taken as a whole, constituted "a single instance of highly unreasonable conduct" within the meaning of Rule 102(e)(1)(iv)(B)(1). They knew that heightened scrutiny was warranted over the ALLL in general and the FAS 114 portion in particular, collateral overvaluation was a specific risk point, and management continued to rely on older or undiscounted appraisals from the first half of 2008 or earlier at year-end 2008, despite contrary market information. Numerous red flags indicated that management was inept and had an incentive to understate losses. Yet, their procedures in testing TierOne's internal control over financial reporting and evaluating the FAS 114 estimates failed to sufficiently address these issues, and KPMG issued a clean audit opinion.[38]

IV. SANCTIONS

The Division asks that Aesoph be denied the privilege of practicing or appearing before the Commission for three years, and Bennett, for two years. Respondents request that the proceeding be dismissed. For the reasons below, Aesoph will be denied the privilege of appearing or practicing before the Commission for one year, and Bennett, for six months.

The purpose of Rule 102 sanctions is not to punish, but to protect the public from future reckless or negligent conduct by professionals who practice before the Commission and to encourage more rigorous compliance with auditing standards in future audits. McCurdy v. SEC, 396 F.3d 1258, 1264-65 (D.C. Cir. 2005). The Commission determines sanctions in a Rule 102(e) proceeding according to the so-called Steadman factors,[39] and it also considers

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[38] Alternatively, each Respondent's participation in the engagement included "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission" within the meaning of Rule 102(e)(1)(iv)(B)(2). The failure to identify a material weakness in TierOne's internal control over financial reporting constitutes one course of such conduct, and the failure to evaluate the FAS 114 portion of the ALLL in accordance with professional standards is another course of such conduct. Both instances demonstrate a lack of due care and failure to obtain sufficient evidence in a high risk and material area of the audit.

[39] The Steadman factors are:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

deterrence. See Steven Altman, Esq., Exchange Act Release No. 63306 (Nov. 10, 2010), 99 SEC Docket 34405, 34435, petition denied, 666 F.3d 1322 (D.C. Cir. 2011). Respondents' auditing lapses, which were negligent, occurred in a single audit. Each continues to audit U.S. public companies as an auditor with KPMG, so the occupation of each will present opportunities for future violations. Consistent with a vigorous defense of the charges, neither has recognized the unreasonable nature of his conduct. Concerning egregiousness, Respondents' conduct fell short of professional standards in their failure to evaluate management's FAS 114 estimates in accordance with professional standards in the face of the need for heightened scrutiny and the corresponding failure to identify a material weakness in TierOne's internal control over financial reporting. Their conduct involved a lack of due care and failure to obtain sufficient evidence to support their audit judgments.

Respondents note that they are highly regarded at their firm and have significant experience, recognized risks associated with the ALLL, worked longer hours on the 2008 audit than on the previous audit, and adequately conducted other areas of the audit. These factors are praiseworthy, but do not obviate the need for a sanction. None of the previous auditing engagements on which either Respondent worked has been the subject of any regulatory complaint; however, a lack of a disciplinary record is not an impediment to imposing sanctions for a respondent's first adjudicated disciplinary violation. See Wendy McNeely, CPA, 105 SEC Docket at 61708; Robert Bruce Lohmann, 56 S.E.C. 573, 582-83 (2003); Martin R. Kaiden, 54 S.E.C. 194, 209-10 (1999). A one-year suspension for Aesoph and six-month suspension for Bennett are appropriate sanctions and consistent with Commission precedent and take account of Aesoph's more responsible role in the engagement.[40]

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

[40] See Wendy McNeely, CPA, 105 SEC Docket 61684 (denying CPA privilege of appearing or practicing before the Commission for six months; audit manager failed to detect improper accounting of a related party transaction, a so-called loan that was a fraudulent misappropriation, which was highly unreasonable conduct); Michael C. Pattison, CPA, Exchange Act Release No. 67900 (Sept. 20, 2012), 104 SEC Docket 58890 (permanently disqualifying CPA from appearing or practicing before the Commission as an accountant; Rule 102(e)(3) proceeding was based on respondent's injunction from violating internal accounting controls and books and records provisions of the securities laws; accountant was complicit in improperly recording back-dated stock options); Gregory M. Dearlove, CPA, Exchange Act Release No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867 (ordering a bar with right to reapply in four years and cease-and-desist order; engagement partner on audit of a public company failed to detect improper accounting of enormous related-party transactions and other matters prior to company's implosion); James Thomas McCurdy, CPA, 57 S.E.C. 277 (2004) (denying CPA privilege of appearing or practicing before the Commission for one year; auditor of a mutual fund failed to obtain sufficient evidence regarding the collectability of a receivable that comprised 25% of the fund's assets), petition denied, 396 F.3d 1258 (D.C. Cir. 2005); Barry C. Scutillo, 56 S.E.C. 714 (2003) (ordering a bar with right to reapply in three years; auditor in high-risk engagement essentially accepted management's valuation of assets, which consisted of purported gold mining properties and CDs purportedly issued by a Russian bank in an unusual transaction); Russell Ponce, 54

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on February 21, 2014, as corrected on March 18, 2014.

VI. ORDER

IT IS ORDERED that pursuant to Section 4C of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-3, and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii), JOHN J. AESOPH, CPA, IS DENIED TEMPORARILY the PRIVILEGE OF APPEARING OR PRACTICING BEFORE THE COMMISSION AS AN ACCOUNTANT for a period of ONE YEAR.

IT IS FURTHER ORDERED that pursuant to Section 4C of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-3, and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii), DARREN M. BENNETT, CPA, IS DENIED TEMPORARILY the PRIVILEGE OF APPEARING OR PRACTICING BEFORE THE COMMISSION AS AN ACCOUNTANT for a period of SIX MONTHS.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of

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S.E.C. 804 (2000) (ordering a bar with right to reapply in five years and cease-and-desist order; CPA violated antifraud provisions, lacked independence due to unpaid fees, changed properly expensed costs to capitalize them based solely on management representations, and inflated value of intangible asset); Robert D. Potts, CPA, 53 S.E.C. 187 (1997), aff'd, 151 F.3d 810 (8th Cir. 1998) (suspending concurring partner for nine months; accounting for asset not in accord with GAAP and contrary to documentary evidence in file he reviewed); Bill R. Thomas, 48 S.E.C. 1007 (1988) (barring, permanently, CPA who violated antifraud provisions, owned stock in firm he audited, and concealed this from his employer, a national accounting firm); Gary L. Jackson, 48 S.E.C. 435 (1986) (barring, permanently, CPA who aided and abetted firm's filing of materially false reports and knowingly accepted firm's valuation of worthless mining claims and of an asset based on a sham transaction with no economic substance); Russell G. Davy, 48 S.E.C. 138 (1985) (barring, permanently, CPA who violated antifraud provisions, accepted management representations about sham transactions, despite red flags and ignored information that he actually knew); Ernst & Ernst, 46 S.E.C. 1234 (1978) (suspending engagement partner for one year, audit manager, for three months, and censuring CPA firm; materially false and misleading financial statements contained sham and improperly accounted for acquisitions, and respondents lacked independence in repeated dependence on management representations concerning significant information despite red flags).

Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak
Administrative Law Judge