STAY ORDER
#2006-149

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF:	)	
Grant Thornton LLP	)	**AA-EC-04-02**
External Auditor For	)	**AA-EC-04-03**
The First National Bank of Keystone	)	
Keystone, West Virginia	)	

ORDER STAYING DECEMBER 7, 2006 ORDERS PENDING JUDICIAL REVIEW BY THE COURT OF APPEALS

On December 7, 2006, the Comptroller signed two orders in this matter requiring respondent Grant Thornton LLP to cease and desist and to pay a civil money penalty ("Orders"). Grant Thornton filed a motion to stay the Comptroller's Orders on December 20, 2006, and on December 22, 2006, the Comptroller ordered Enforcement Counsel for the Office of the Comptroller of the Currency ("OCC") to file any response to respondent's motion no later than January 3, 2007. In a motion filed on December 26, 2006, Grant Thornton requested relief in the form of an interim stay pending the Comptroller's consideration of Grant Thornton's original motion, noting that the rules of the D.C. Circuit require petitioners to file with the Court of Appeals a motion for a stay of an agency order seven calendar days before its effective date. On the morning of December 27, 2006, Enforcement Counsel filed its opposition to Grant Thornton's motion for an interim stay, to which Grant Thornton filed a reply later in the day. On December 28, 2006 Enforcement Counsel filed its opposition to Grant Thornton's motion for a stay pending judicial review. For the reasons stated below, the Comptroller grants Grant Thornton's motion for a stay pending judicial review and denies Grant Thornton's motion for an interim stay as moot.

Discussion

Under the OCC's rules of practice, "[t]he Comptroller may, in his or her discretion, and on such terms as he or she finds just, stay the effectiveness of all or any part of an order pending a final decision on a petition for review of that order." 12 C. F. R. § 19.41. Grant Thornton argues that a stay of the Comptroller's December 7, 2006 Orders is appropriate because its appeal raises serious legal questions regarding the merits of the Comptroller's decision, Grant Thornton would suffer irreparable harm if the Orders were not stayed, the OCC would not suffer any harm from a stay, and the public interest favors a stay.

The Comptroller disagrees with each of respondent's challenges to the Comptroller's Orders. The Comptroller's application of federal banking law to the conduct by Grant Thornton is squarely within the language and intent of the statutes authorizing the Comptroller to bring enforcement actions against independent contractors, including accountants, who recklessly participate in an unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or significant adverse effect on, a national bank. *See* 12 U.S.C. § 1813(u). As explained in the December 7, 2006 decision, the facts establish that Grant Thornton's conduct in performing its audit of the First National Bank of Keystone, Keystone, West Virginia ("Keystone"), made Grant Thornton an institution-affiliated party and warranted the imposition of the Cease and Desist Order and assessment of a civil money penalty. Grant Thornton's request for a stay raises substantially the same arguments that were made in Grant Thornton's exceptions to the decision of the Administrative Law Judge, and that were addressed in the Comptroller's decision. Consequently, the Comptroller finds no basis for granting relief based on Grant Thornton's claim that there are serious legal questions presented by the Comptroller's December 7, 2006 Orders.

The Comptroller also rejects respondent's argument that the Cease and Desist Order goes beyond the scope of remedying Grant Thornton's misconduct in conducting the Keystone audit. Each of the requirements cited by respondent in its motion for a stay is based on auditing requirements and is related directly or indirectly to a failure or weakness with respect to Grant Thornton's audit of Keystone.

Grant Thornton has submitted an affidavit generally stating that the firm will suffer irreparable harm if it is subject to the December 7, 2006 Cease and Desist Order because its ability to attract new depository institution clients would be impaired. It is reasonable to conclude that some potential depository institution clients would consider Grant Thornton's reputation in determining whether to select the firm for audit or accounting services. It is possible that some of those clients would consider a cease and desist order that has been stayed during an appeal of the order to be incrementally less important to assessing the reputation of an auditor than an operative cease and desist order that is being appealed. The extent of this difference, however, is highly speculative and, even if assumed to exist, would fall far short of the destruction of the appellant's business that warranted the stay in *Washington Metropolitan Transit Comm'n v. Holiday Tours, Inc.* 559 F.2d 841 (D.C. Cir. 1977). Respondent has simply not shown that the difference constitutes the type of irreparable harm that would justify a stay under the standards established by the D.C. Circuit.

The Comptroller also disagrees with respondent's assertion that the interests of the OCC would not be harmed by a stay. Respondent continues to conduct audits of insured financial institutions and, apparently, continues to solicit new clients among financial institutions. Respondent engaged in serious misconduct in conducting the audit of Keystone and the December 7, 2006 Cease and Desist order requires respondent to take steps designed to help

assure that this misconduct will not be repeated at other insured financial institutions. This further assurance of respondent's compliance with Generally Accepted Auditing Standards and other prudential requirements for auditing insured financial institutions helps protect the safety and soundness of those institutions that use Grant Thornton for auditing and other accounting services. This not only provides further assurance that OCC can rely on the auditing work performed by Grant Thornton because it will be conducted according to the standards set forth in the Cease and Desist Order, it also serves the public interest by providing further assurance that the public may justifiably rely on depository institution audits prepared by Grant Thornton.

Even though the Comptroller concludes that respondent has failed to demonstrate that a stay is warranted under the standards set forth in *Washington Metropolitan Transit Comm'n v. Holiday Tours, Inc.*, 559 F.2d 841 (D.C. Cir. 1977), the Comptroller is not prepared to conclude that Grant Thornton would not suffer any injury in the absence of a stay of the December 7, 2006 Orders. Therefore, in accordance with 12 C.F.R. § 19.41, the Comptroller, in the exercise of his discretion, grants respondent's motion for a stay of the Orders pending judicial review in the Court of Appeals.

IT IS SO ORDERED, this 29th day of December, 2006.

/s/

JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY

#2006-149

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF:	)	
Grant Thornton LLP	)	**FINAL DECISION**
External Auditor For	)	**AND ORDER**
The First National Bank of Keystone	)	**AA-EC-04-02**
Keystone, West Virginia	)	**AA-EC-04-03**

JOHN C. DUGAN, Comptroller of the Currency:

INTRODUCTION

Grant Thornton LLP ("Grant Thornton") is a nationally recognized accounting firm that conducted an external audit of First National Bank of Keystone, Keystone, West Virginia ("Keystone" or the "bank") required by a formal agreement between the bank and the Office of the Comptroller of the Currency ("OCC"). Grant Thornton issued an unqualified opinion stating that, after following Generally Accepted Auditing Standards ("GAAS"), Grant Thornton had obtained reasonable assurance that the bank's financial statements for calendar year 1998 were not materially misstated and were prepared in accordance with Generally Accepted Accounting Principles ("GAAP"). Several months later, the OCC discovered that the bank was hopelessly insolvent and in September 1999 appointed the Federal Deposit Insurance Corporation ("FDIC") as receiver.

The OCC's Enforcement and Compliance Division ("E&C") initiated administrative enforcement proceedings against Grant Thornton by filing notices of charges seeking issuance of a cease and desist order ("C&D") to address serious deficiencies identified by the OCC in connection with Grant Thornton's audit of Keystone and assessing a $300,000 civil money penalty ("CMP"). Following a hearing, Administrative Law Judge Ann Z. Cook (the "ALJ")

issued a decision ("RD") recommending dismissal of the enforcement actions because she concluded that Grant Thornton was not an institution-affiliated party ("IAP").[1]

Upon consideration of the entire record, including the exceptions filed by the parties, the Comptroller finds as follows: In connection with the audit of Keystone, Grant Thornton acted as an IAP within the meaning of 12 U.S.C. § 1813(u)(4). Specifically, Grant Thornton, as an independent contractor for Keystone, participated in an unsafe or unsound practice by failing to comply with GAAS in planning and conducting its audit of Keystone's 1998 financial statements. Further, Grant Thornton recklessly participated in the unsafe or unsound practice by conducting the audit "in disregard of, and evidencing a conscious indifference to, a known or obvious risk of a substantial harm,"[2] that bank regulators, the bank's shareholders and the public would rely to their detriment upon financial statements that contained serious material inaccuracies.

An auditor's opinion is based upon the principle of obtaining *reasonable assurance* that the financial statements of the entity being audited are not materially misstated. Auditors do not function as insurers and their reports do not constitute a guarantee. Accordingly, an auditor does not become liable to sanctions under the laws governing the activities of insured depository institutions simply by failing to comply with the technical requirements of GAAS or merely failing to detect fraud or misstatement. It is only when the conduct of an audit for an insured

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[1] The OCC's authority to impose a CMP and issue a C&D is found at 12 U.S.C. §§ 1818(b)(1) (C&D) and 1818(i)(2)(B)(II) (CMP). Both section 1818(b)(1) and 1818(i)(2)(B)(II) apply to an IAP as defined in 12 U.S.C. § 1813(u)(4). An IAP is defined as "any independent contractor (including any . . . accountant) who . . . recklessly participates in . . . any unsafe or unsound practice . . . which caused or is likely to cause more than a minimal financial loss to, or significant adverse effect on, the insured depository institution." 12 U.S.C. § 1813(u)(4).

[2] *Cavallari v. Office of the Comptroller of the Currency*, 57 F.3d 137, 142 (2d Cir. 1995).

depository institution departs so far from the standards required by GAAS that it becomes evident that the audit was conducted in disregard of, or with conscious indifference to, the risk of harm to those who might rely on the auditor's opinion regarding the absence of material misstatements in the financial statements, that an auditor or auditing firm may become liable for sanctions under the federal banking laws. This is such a case.

The record shows that Grant Thornton recklessly participated in an unsafe or unsound practice with respect to its audit of Keystone. In the context of an acknowledged maximum risk audit, an auditor acts with conscious indifference to a known or obvious risk of substantial harm whenever the auditor fails to execute basic procedures concerning the most material entries on an insured depository institution's financial statement. This occurs when the auditor, with respect to the verification of reported assets, had in its possession evidence of the type required by GAAS that directly and unequivocally demonstrated that a bank is overstating its assets by hundreds of millions of dollars, but relies instead on evidence that does not comply with GAAS. Likewise, this occurs when the auditor, with respect to income verification, contrary to GAAS, relies upon financial data obtained from the bank that it knew or should have known was unreliable when evidence required by GAAS was readily available at the bank and would have demonstrated that the bank received almost none of the $98 million in interest income it was reporting. The record shows that this occurred in Grant Thornton's audit of Keystone.

Finally, Grant Thornton's conduct resulted in more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution. Accordingly, based upon the entire record, the Comptroller finds that Grant Thornton, as an IAP, recklessly "engaged" in an unsafe or unsound practice in conducting the "business" and "affairs" of Keystone, within the

meaning of 12 U.S.C. §§ 1818(b)(1) and 1818(i)(2)(B)(II) and, thus, should be subject to a C&D and assessed a CMP. These findings are supported by the Comptroller's Findings of Fact and Conclusions of Law ("FFCL") set forth in Appendix A, which are incorporated herein.[3] Because these findings establish that it is appropriate to issue a C&D and assess the CMP sought by E&C, an order to that effect is set forth at the conclusion of this decision.

FACTUAL BACKGROUND

A. Keystone's Pre-1998 Securitization Program

In 1992, Keystone radically changed its business plan from that of a small, traditional lender and began growing rapidly through the securitization of high-loan-to-value, second and third mortgage loans. FF 83. Initially, Keystone's securitization program was conducted as follows: Keystone, through its operating subsidiary, Keystone Mortgage Corporation ("KMC"), would acquire loans from large originators located throughout the country. FF 84. The bank initially used brokered deposits and Federal Home Loan Bank of Pittsburgh ("FHLB-Pittsburgh") advances to fund these acquisitions. FF 84. Keystone would re-underwrite these loans to assure itself that the loans met securitization standards. FF 85.

Keystone used asset servicers to collect the principal, interest and penalties on the loans held prior to the securitization, and the servicers sent Keystone monthly interest income checks on the loans. FF 86. Once it had purchased a sufficient number of loans to execute a securitization, Keystone would establish a trustee to whom the loans would be sold. FF 87. In turn, the trustee would issue and sell securities that represented a proportional beneficial interest

[3] Paragraph numbers for the findings and conclusions in the FFCL are cited as "FF ___ and "CL ___," respectively.

in the loan payments and a proportional ownership interest in the loans in the pool. FF 87. The trustee would compensate Keystone for the loans by delivering to Keystone the cash proceeds from the sale of the securities plus the residual interest in the loan pool. FF 87. Between 1992 and 1997, Keystone's asset size reportedly grew from approximately $100 million to $1 billion. FF 82, 83.

B. Keystone's Arrangement with United

In February 1998, Keystone finalized an arrangement with United National Bank, Wheeling, West Virginia ("United") that significantly changed Keystone's securitization program. Under this arrangement, Keystone began purchasing loans as agent for United, *instead of purchasing loans for securitization as principal for its own account*. FF 89. Keystone would notify United on a daily basis of the loans available for acquisition and United would provide funding for their acquisition. FF 89, 90. Keystone would "re-underwrite" these United loans just as Keystone had done with respect to loans it bought in its own name prior to the United arrangement. FF 90. Asset servicers, retained by Keystone, serviced the loans owned by United up to the time of the next securitization. FF 94. Because United owned the loans, the servicers sent United, not Keystone, monthly checks in connection with the interest income on the loans they were servicing for United. FF 96. In 1998, United acquired approximately $960 million in loans under this arrangement. FF 102. Keystone executed two securitizations (May and September) using approximately $500 million in loans owned by United. FF 103.

C. OCC's Criticism of Keystone's Records and Accounting

Almost from the beginning of Keystone's securitization program, the OCC examiners criticized: (1) Keystone's accounting for its residual interests in the securitizations because of its

impact on Keystone's capital position; (2) the bank's internal controls; (3) the accuracy of the bank's books and records; and (4) the filing of inaccurate quarterly Reports of Condition and Income ("Call Reports"). FF 127. The OCC's 1997 report of examination ("ROE") was particularly critical of the bank, and indicated that supervision of Keystone had been transferred from the district office to the OCC's Special Supervision Division in Washington. FF 128. The OCC's 1997 ROE gave Keystone an unsatisfactory composite CAMELS rating of "3," and an unsatisfactory management rating of "4." FF 129. The OCC required Keystone to file amended Call Reports for the first and second quarters of 1997. FF 130.

In February 1998, the OCC informed Keystone that its Call Report for the third quarter of 1997 was inaccurate and required that they be amended. FF 130. The OCC pointed out that the bank had not addressed many of the accounting and internal controls problems noted in the 1997 ROE. FF 130. On May 8, 1998, the OCC communicated to Keystone that it was considering the imposition of civil money penalties in connection with Keystone's inaccurate 1997 Call Reports.[4] FF 131.

In May 1998, Keystone and the OCC entered into a formal supervisory agreement ("Formal Agreement") related to the accounting and reporting irregularities noted in the OCC's 1997 ROE. FF 132. The Formal Agreement required, among other things, that Keystone correct the accounting and internal control deficiencies noted in the OCC's 1997 ROE and retain a nationally recognized accounting firm to audit the bank. FF 133. Specifically, the Formal Agreement required the national accounting firm be retained "to perform an audit of the Bank's

[4] In December 1998, Ms. Terry Church, a director and the bank's senior vice president, paid a CMP of $13,000 and other directors paid CMPs of $2,000 each for filing inaccurate Call Reports.

mortgage banking operations and determine the appropriateness of the Bank's accounting for purchased loans and all securitizations." FF 133, 134.

One month after the Formal Agreement was effective, the OCC, in June 1998, informed Keystone that it was "undercapitalized" and, accordingly, Keystone was prohibited from accepting, renewing, or rolling over brokered deposits. FF 135. In addition, the FHLB-Pittsburgh placed the bank's line of credit in "full collateral status," *i.e.*, began requiring physical possession of loans used by Keystone as collateral for FHLB-Pittsburgh borrowings. FF 135. Being "undercapitalized" also meant that Keystone was restricted in terms of asset growth and prohibited from paying dividends. FF 135.

In July 1998, Keystone chose Grant Thornton as its external auditor and Grant Thornton began providing accounting services at that time, even though the audit engagement letter was not finalized until September 1998 and the audit did not begin until late December 1998. FF 136, 137. At the same time that Grant Thornton began providing services to the bank in the summer of 1998, the OCC was in the process of completing its 1998 ROE. FF 137. Grant Thornton was aware that the OCC's 1998 ROE downgraded the bank's composite CAMELS rating from "3" to "4," and downgraded the management rating for the bank from "4" to "5." FF 137, 139, 140, 150.

In early December 1998, Grant Thornton representatives attended a meeting between the OCC and Keystone management to discuss the findings and conclusions of the OCC's 1998 ROE. FF 139. In the presence of Grant Thornton, the OCC examiners stated that Keystone had misstated its assets by about $90 million (almost ten percent of the bank's reported assets) in connection with three separate misstatements. FF 139. In addition, the OCC indicated that Ms.

Terry Church appeared to have deliberately mischaracterized $760 million of the bank's assets in calculating the bank's risk-based capital for call reporting purposes. FF 140.

The misclassification of assets by Ms. Church had the effect of erroneously categorizing Keystone as "well capitalized" under the prompt corrective action standards of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Pub. L. No. 102-242, 105 Stat. 2236 (1991). FF 140, 141. Because the corrected Call Report showed that Keystone was not "well capitalized," its use of brokered deposits as a funding source was restricted. FF 142. The OCC informed Ms. Church and others at Keystone that it was contemplating assessing new CMPs against them in connection with the findings in the OCC's 1998 ROE.[5] FF 151.

D. Grant Thornton's Audit

GAAS requires that auditors possess appropriate skill and training, maintain an independent mental attitude, and exercise "due professional care." FF 22–28. "Due professional care" requires the auditor to plan and perform the audit in order to obtain *reasonable assurance* that the financial statements are free from material misstatements whether caused by error or fraud.[6] The "due professional care" standard also mandates that auditors be assigned tasks and supervised in a manner consistent with their level of skill and experience. "Due professional care requires the auditor to exercise *professional skepticism*."[7] "Professional skepticism," in turn,

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[5] In July 1999, the OCC assessed a $100,000 CMP against Ms. Church, and $25,000 CMPs against other directors and officers of Keystone. These CMPs were stayed when the OCC closed the bank and appointed the FDIC as receiver.

[6] To be sure, however, GAAS is based upon the premise of "reasonable assurance," and an auditor is neither an insurer nor a guarantor. FF 31 (GT Ex. 210 (AU 230.13)).

[7] FF 25 (GT Ex. 210 (AU 230.07) (emphasis original)). "Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence." FF 25. Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism is required throughout the audit process. FF 28 (GT Ex. 210 (AU 230.08)).

dictates that an auditor not be satisfied with less than persuasive evidence. FF 26. In addition, "professional skepticism" is important in evaluating the results of the third party confirmations, and requires that "significant" confirmations be obtained in writing. FF 73.

As part of the audit planning process, the auditor is required to assess the risk of material misstatements (whether caused by error or fraud). FF 29, 38, 63. In order to properly assess this risk, the auditor is required to obtain a level of knowledge of the entity's business sufficient to enable him or her to understand the events, transactions, and practices that may have a significant effect upon the financial statements. FF 18–21. The auditor's understanding of the internal controls may heighten concern about the possibility of material misstatements, and impact the nature, timing, and extent of tests to be performed. FF 34, 43. As an integral part of the risk-assessment process, the auditor is required to assess the risk of material misstatements in the financial statements due to fraud. FF 47. Higher detection risk[8] requires the auditor to modify or expand procedures, particularly in critically important areas, because the degree of "professional skepticism" required increases as the risk that material misstatements will go undetected increases. FF 32, 36, 41, 59.

In addition to GAAS, Grant Thornton was operating under a settlement order (the "OTS Order") it entered into with the Office of Thrift Supervision ("OTS"), which remained in effect

[8] "Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion." FF 32 (GT 212 (AU 312.12)). "Whenever the auditor has concluded that there is a significant risk of material misstatements of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision." FF 32 (GT 212 (AU 312.17)). "Inherent and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at his or her discretion." FF 32 (GT 212 (AU 312.28)).

until 2001 and related to accounting services that a predecessor of Grant Thornton performed for San Jacinto Savings Association of Bellaire, Texas.[9] FF 4–7. The OTS Order required Grant Thornton when auditing any insured depository institution to conduct a pre-audit review of the institution's internal controls and assess the risks that the institution's financial statements contained material misstatements. FF 6. In this regard, the OTS Order required that Grant Thornton test Keystone's internal controls for reliability prior to Grant Thornton relying upon tests based upon internally generated bank financial data. FF 6.

In preparing the 1998 audit plan for Keystone, Grant Thornton conducted an environmental risk assessment, as required by GAAS and the OTS Order, to determine what procedures were necessary to carry out the audit. FF 152. Grant Thornton planned the audit of Keystone with knowledge of the following facts that clearly demonstrated heightened audit risk: (1) in a short period of time Keystone had grown rapidly in asset size and profitability (FF 82, 83); (2) Keystone was heavily involved in significant and complex securitizations (FF 82–114); (3) Keystone faced significant liquidity risk (FF 148, 149, 167); (4) Keystone was troubled and undercapitalized (FF 135, 167); (5) Grant Thornton had been retained by Keystone in order to comply with the OCC Formal Agreement that required the bank to retain an external auditor to resolve the bank's accounting inaccuracies and deficiencies and to establish an internal control structure (FF 132–134); (6) the OCC had just downgraded the bank to an unacceptable composite "4" CAMELS rating, and downgraded Keystone's management to the lowest rating of "5" (FF 150); (7) the FBI had investigated Ms. Church with respect to illegal "kickbacks" related

[9] Grant Thornton consented to this order to resolve a previous enforcement action against Grant Thornton's predecessor firm, *In the Matter of Grant Thornton, LLP, formerly known as Alexander Grant & Company*, OTS Order No. AP 96-30.

to the bank's residential lending (FF 171); (8) Mr. Michael Graham, a vice president of KMC, was cited by the OCC as being responsible for an unexplained $31 million "input error" in the bank's accounting for residual assets (FF 139); (9) Keystone recently had recorded ownership of $44 million in trust accounts even though they were not Keystone assets (FF 139); (10) Keystone also recently had claimed ownership of $16 million in residual interests in securitizations even though Keystone had pledged those interests to other parties (FF 139); (11) the bank had a history of filing inaccurate Call Reports, key insiders had been assessed CMPs in connection with those inaccuracies, and the OCC was considering additional CMPs against these same insiders (FF 151); and (12) the OCC examiners had accused Ms. Church of manipulating Call Reports so that the bank's "well capitalized" status under FDICIA continued to be reported even though inaccurate (FF 140).

Grant Thornton ultimately categorized the Keystone audit as a "maximum" risk audit in accordance with the dictates of its audit manual that purported to carry-out the requirements of GAAS.[10] FF 184, 188. Under the Grant Thornton audit manual, a "maximum" assessment for environmental risk required Grant Thornton to conduct what the manual defined as a "Comprehensive" audit – which called for the highest level of detailed testing of the three audit categories recognized by Grant Thornton. FF 186. Given the facts known by Grant Thornton, this was clearly appropriate and required by GAAS.

Grant Thornton staffed the audit with a lead auditor, Mr. Stanley Quay, and a project manager, Ms. Susan Buenger, neither of whom had any experience with a "Comprehensive"

[10] GAAS requires auditing firms to provide guidance to its auditors about how to conduct an audit in accordance with GAAS. FF 74.

audit involving a "maximum risk" assessment. FF 188. Ms. Buenger, the auditor assigned to the verification of assets and income related to the bank's securitization program, had little experience with securitizations, and received neither material guidance nor supervision from Mr. Quay, the auditor in charge, or other Grant Thornton personnel. FF 121.

The audit plan called for Grant Thornton to: (1) verify the bank's approximately $500 million in assets reportedly being serviced by third parties by contacting those servicers and requesting written confirmations; and (2) test Keystone's $98 million in reported interest income from loans serviced by third parties for "reasonableness." FF 179. In connection with the verification of asset ownership, Grant Thornton received from Advanta Mortgage Corporation USA ("Advanta") written confirmation that it was servicing $6.3 million in Keystone loans; this figure was substantially and clearly different from the $242 million in assets the bank was reporting.[11] FF 200. Grant Thornton followed up several weeks later with a telephone call and, according to Grant Thornton, was told that there was another pool of Keystone loans in the amount of $236 million. FF 202. Immediately after this call, however, the Advanta representative sent an e-mail to Grant Thornton stating that the pool of $236 million in loans was owned by United. FF 203. Despite this significant discrepancy, Grant Thornton did not request that Advanta reconcile the disparate dollar amounts either orally or, as required by GAAS, in writing, and concluded incorrectly that Advanta was servicing $242 million in Keystone loans

[11] A confirmation letter was also sent to Compu-Link Loans Service, Inc. ("Compu-Link"), because Keystone was reporting that Compu-Link was servicing $227 million in Keystone assets. Compu-Link errantly sent a confirmation letter to Grant Thornton stating that it was servicing $227 million in loans for Keystone, when in fact it was servicing $227 million in United loans that had been acquired by Keystone as agent for United pursuant to the Keystone/United arrangement. FF 200. Compu-Link was only servicing $14 million in loans owned by Keystone. FF 200. Compu-Link became aware of the error during a conference call among Compu-Link, Grant Thornton auditors, and OCC examiners in August 1999, when OCC examiners were in the process of uncovering Keystone's fraud. FF 200.

($6.3 million + $236 million). FF 212. In reality, Advanta was servicing only $6.3 million in Keystone loans as Advanta had stated in its original written confirmation to Grant Thornton.

In connection with the audit of Keystone's reported $98 million in interest income from Keystone loans held for securitization that were serviced by third party asset servicers, Grant Thornton conducted tests that, instead of verifying that the income actually had been received by the bank, merely attempted to demonstrate that the interest income reported was "reasonable" in light of the volume and characteristics of the reported loans. FF 66, 236. These tests were based upon fraudulent financial information with respect to the amount of interest income earned by the bank that Grant Thornton obtained directly from Keystone. FF 236, 237. Keystone overstated its interest income from loans reportedly serviced by asset servicers by almost the entire $98 million. FF 261.

In April 1999, Grant Thornton issued its audit report stating that the audit had been performed in accordance with GAAS and that Grant Thornton had obtained reasonable assurance that the bank's financial statements were free from material misstatements. FF 253. However, in August 1999, the OCC examiners requested and obtained information directly from the servicers (including Advanta), despite efforts by Keystone management to prevent disclosure, showing that Keystone was vastly overstating its assets. FF 256–258. After this information was brought to the attention of Grant Thornton, the auditors conducted another "test of reasonableness" in an attempt to demonstrate that Keystone had received the income reported, but the lead auditor, Mr. Quay, concluded that the analytical test was insufficient as substantive evidence. FF 256. Grant Thornton eventually reviewed actual remittances and bank records (checks and wire transfers) and did not find cash income sufficient to support the volume of loans reported by

Keystone. FF 260. The OCC determined that the bank was hopelessly insolvent and appointed the FDIC as receiver in September 1999. FF 260.

Between the time Grant Thornton issued its audit report in April 1999 and the time the bank was placed in receivership, Keystone paid dividends totaling over $1 million. FF 254. Subsequently, a group of Keystone insiders, including Ms. Church and Mr. Graham, received felony convictions for, among other things, obstruction of the OCC's 1998 bank examination, bank embezzlement, and money laundering. FF 261.

PROCEDURAL BACKGROUND

A. The Enforcement Notices

E&C charged that Grant Thornton recklessly participated in an unsafe or unsound practice that caused more than a minimal financial loss to, or a significant adverse effect on, Keystone when, having determined that the Keystone audit presented maximum risk that errors and irregularities could cause the financial statements to contain material misstatements and that Keystone's internal controls were inadequate to detect material misstatements, it disregarded the requirements of GAAS and the OTS Order in planning and conducting the audit. Specifically, E&C charged that Grant Thornton acted recklessly in verifying the bank's assets when it failed to pursue and resolve the inconsistency between what Grant Thornton believed it was told in a telephone conversation with an Advanta representative regarding Keystone's ownership of loans and a written confirmation and e-mail from Advanta. C&D Notice at 20; CMP Notice at 17–18. E&C also charged that Grant Thornton acted recklessly in using management summaries and reports to confirm income instead of reviewing checks, remittances, wire receipts, or other core financial documents. *Id.* E&C assessed a $300,000 CMP (CMP Notice at 1) and sought a C&D

that, among other things: (1) places restrictions upon Grant Thornton offering non-audit services to financial institutions it audits; (2) limits the number of consecutive years Grant Thornton audit personnel could audit a financial institution; and (3) requires Grant Thornton to document its compliance with GAAS in connection with audits of financial institutions. C&D Notice (Proposed Order).

B. The Administrative Law Judge's Recommended Decision

Following a hearing, the ALJ issued a RD concluding that all statutory elements necessary for Grant Thornton to have acted as an IAP had been established except the requirement that Grant Thornton act "recklessly" in conducting the audit. RD at 6-7, 15, 34. Specifically, the ALJ concluded that, although the "audit was not perfect," Grant Thornton had not acted "recklessly." Accordingly, she recommended dismissal of the charges against Grant Thornton. RD at 15.

C. The Exceptions Filed by the Parties

1. Enforcement Counsel

E&C contends that recklessness must be determined in the context of the relevant standard of care and that, further, GAAS provides that standard. E&C Exceptions ("E&C Exc.") at 14–16. E&C objects to the ALJ's findings and conclusion because the ALJ failed to: (1) discuss or even cite relevant GAAS provisions in connection with the verification of assets reportedly serviced by third party servicers (E&C Exc. at 17); or (2) apply GAAS properly in connection with the audit of reported interest income from such loans. E&C Exc. at 21. Had the ALJ analyzed the evidence in light of what GAAS required under the circumstances, E&C asserts, the ALJ would have concluded that Grant Thornton recklessly participated in the audit of

Keystone and that all statutory requirements for the imposition of a CMP and the issuance of the C&D had been satisfied.

2. Grant Thornton

Grant Thornton challenges the ALJ's findings of fact and conclusions of law with respect to the elements necessary to establish that Grant Thornton acted as an IAP, except those supporting her determination that Grant Thornton did not act "recklessly." Grant Thornton asserts that: (1) the "independent contractor" element of IAP status applies only to individual auditors (GT Exc. at 7–11); (2) planning and conducting the audit did not equate to "participation" in an unsafe or unsound practice (GT Exc. at 11–14); and (3) the audit opinion did not cause financial loss or harm. GT Exc. at 15–19. Grant Thornton's remaining exceptions address the OCC examiners' review of Grant Thornton's workpapers and the fact that the OCC did not disclose to Grant Thornton that the OCC had submitted criminal referrals to the Department of Justice with respect to Keystone management.[12] GT Exc. at 23–28.

DISCUSSION

For the reasons explained below, the Comptroller rejects the ALJ's recommendation of dismissal (RD at 34) and concludes that Grant Thornton acted as an IAP in connection with the Keystone audit. The Comptroller further concludes that the grounds necessary to impose a C&D and assess a CMP have been established. In rendering this decision, the Comptroller has considered Grant Thornton's exceptions and rejects each exception as lacking merit. Grant Thornton's exceptions are either unsupported by the record evidence or unnecessary to the

[12] Pursuant to 12 C.F.R. § 19.40(b), Grant Thornton requested oral argument before the Comptroller on the recommended findings, conclusions, decision, and order of the ALJ.

determination of whether to impose a C&D or assess a CMP. Likewise, E&C filed numerous and lengthy exceptions and to the extent not addressed in this Final Decision, they are rejected.

I. GRANT THORNTON PARTICIPATED IN AN "UNSAFE OR UNSOUND PRACTICE"

The ALJ concluded that Grant Thornton participated in an unsafe or unsound practice by issuing "an unqualified opinion containing materially inaccurate information about the Bank, which can be deemed a practice contrary to accepted banking standards." RD at 6-7. Grant Thornton asserts, in its exceptions, that the ALJ identified the audit itself, rather than the fraud, as the unsafe or unsound practice, and that, in doing so, the ALJ diverged from E&C's assertions in the C&D and CMP notices of charges. GT Exc. at 12. Grant Thornton states that, accordingly, the only question at issue here is whether Grant Thornton's issuance of an erroneous audit opinion constituted "participation" in the fraud of Keystone's management. *Id.*

Grant Thornton is mistaken that E&C asserted only that the material misstatements in the financial statements was an unsafe or unsound practice. E&C's notices charge that Grant Thornton's audit with respect to asset and income verification "violated GAAS and constituted reckless participation in unsafe or unsound banking practices in that . . . [they] facilitated the continued false and fraudulent representation of the Bank's" assets and income. C&D Notice at 20; CMP Notice at 17-18. The notices, therefore, assert that the violation of GAAS in carrying out the audit constituted participation in an unsafe or unsound practice, and this unsafe or unsound practice assisted the bank in continuing its own unsafe and unsound practice (material misstatements about assets and income due to fraud). Clearly, Grant Thornton itself "participated" in an unsafe or unsound practice when it violated GAAS in carrying out its audit.

Grant Thornton cites to several non-banking criminal cases that have interpreted the word "participate" narrowly to require active involvement or affirmative conduct in support of wrongdoing by another. GT Exc. at 12–13. Because Grant Thornton did not know about the fraud being perpetrated by Keystone officers and directors, Grant Thornton argues that it did not "participate" in that fraud within the meaning of 12 U.S.C. § 1813(u)(4). GT Exc. at 11-14. Aside from mischaracterizing the E&C charges, this argument is without merit because its interpretation of the word "participates" would require "knowing" participation. However, 12 U.S.C. § 1813(u)(4) includes as an IAP any auditor that "knowingly or recklessly participates" in an unsafe or unsound practice. Under Grant Thornton's construction "recklessly" would be read out of the definition of an IAP. Grant Thornton acknowledges in its exceptions that its interpretation would cause this result, stating "[d]istorting the term 'participate' to include an *absence* of knowledge about the wrong would turn the word [participate] on its head." GT Exc. at 14 (emphasis original). Plainly, the statute by its terms precludes the interpretation advocated by Grant Thornton.

Moreover, Grant Thornton's interpretation of the word "participates" is contrary to the remedial purpose of 12 U.S.C. §§ 1813(u)(4) and 1818(i)(2)(B). One of the ways that the Financial Institutions Reform, Recovery and Improvement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989), strengthened enforcement authority was by explicitly authorizing actions against auditors whose failed audits delayed regulatory action and increased the cost of failed bank resolution. 1989 U.S.C.C.A.N. at 97. Indeed, Grant Thornton's audit failure is the type of audit failure that Congress intended to address in FIRREA. The House Committee on Banking, Finance and Urban Affairs and a task force of its Subcommittee on Financial

Institutions Supervision, Regulation and Insurance held separate hearings that elicited testimony and statements highly critical of independent auditors of failed thrifts, and issued reports citing to two General Accounting Office ("GAO") reports addressing the role of auditors in financial institution failures.[13] Moreover, the Senate Report quoted from one of the GAO reports: "A recent GAO report concluded that, in six of eleven cases studied, 'CPA's did not adequately audit and/or report the S&L's financial or internal control problems in accordance with professional standards.'"[14]

A. <u>GAAS Provided the Standard of Care</u>

FIRREA does not define what constitutes an "unsafe or unsound practice." *Cavallari v. Office of the Comptroller of the Currency*, 57 F.3d 137, 142 (2d Cir. 1995). However, in *Cavallari*, which was an IAP case involving an attorney, the U.S. Court of Appeals for the Second Circuit agreed with the Comptroller that an "unsafe or unsound practice" is conduct deemed contrary to accepted standards of banking operations that might result in abnormal risk or loss to a banking institution or shareholder. *Id.*; *see also Simpson v. OTS*, 29 F.3d 1418 (9th Cir. 1994) (citing *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990)).

GAAS is designed to assist the auditor in obtaining reasonable assurance that the audited entity's financial statements do not contain material misstatements, and GAAS provides the

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[13] *See* Failure of Independent CPA's to Identify Fraud, Waste and Mismanagement and Assure Accurate Financial Position of Troubled S&L's: Hearing before the Committee on Banking, Finance and Urban Affairs, House of Representatives, 101st Cong. 101-7 (1989) at 213-26, citing GAO, "CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems" (Feb. 1989); and Adequacy of Examination Levels and Compensation: Hearing before the Examination Audit and Review Task Force of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Banking Committee, 101st Cong. 101-61 (1989), citing GAO, "Report on Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management" (May 1989).

[14] S. Rep. No. 101-19, at 41 (1989), citing GAO Report on Failures of CPA Audits in the House Hearing, at 215.

standard of care in preparing and conducting audits of insured financial institutions.[15] Indeed, there is no dispute that Grant Thornton was required, as a matter of law, to "meet or exceed the scope and procedures required by" GAAS in connection with its audit report. 12 U.S.C. § 1831m(f)(1).

Although concluding that Grant Thornton had participated in unsafe or unsound practices, the ALJ failed to compare Grant Thornton's conduct to what GAAS demanded under the circumstances of Grant Thornton's audit of Keystone's 1998 financial statements. Accordingly, the Comptroller rejects the ALJ's conclusion that Grant Thornton participated in an unsafe or unsound practice *because* Grant Thornton issued "an unqualified opinion containing materially inaccurate information about the Bank." RD at 6-7. An auditor cannot achieve "absolute assurance that material misstatements in the financial statements will be detected." FF 30. GAAS makes plain that an auditor's opinion "is based on the concept of obtaining reasonable assurance" and an "auditor is not an insurer and his or her report does not constitute a guarantee." FF 31; *see also* FF 29, 30. Had Grant Thornton complied with GAAS, Grant Thornton's issuance of an unqualified audit opinion containing material misstatements would not necessarily have constituted an unsafe or unsound practice. Under the circumstances of this case, however, the Comptroller concludes that Grant Thornton participated in an unsafe or unsound practice because of its numerous and serious violations of GAAS in planning and conducting its audit of Keystone.

[15] *Accord Potts v. SEC*, 151 F.3d 810, 812-13 (8th Cir. 1998) (finding that GAAP and GAAS "establish[] norms of accounting profession").

B. Grant Thornton's Confirmation of Loans Reportedly Serviced by Advanta Violated GAAS

Keystone asserted that a third party loan servicer, Advanta, was servicing approximately $242 million in loans owned by Keystone. FF 192. Grant Thornton knew that confirmation of this loan balance was material because it represented approximately 25 percent of Keystone's reported assets. FF 194. Grant Thornton also knew that this was a maximum risk audit, and GAAS requires the greatest degree of "professional scrutiny" in such situations. FF 184, 188.

Grant Thornton incorrectly confirmed what Keystone was reporting. As the evidence establishes, Grant Thornton obtained written confirmation that Advanta was servicing only $6.3 million in loans owned by the bank. The ALJ excused Grant Thornton's failure to discover that Advanta was servicing only $6.3 million in loans based upon the ALJ's unsubstantiated belief that bank management must have interfered with Grant Thornton's confirmation efforts with Advanta.[16] RD at 11. Moreover, in reaching this conclusion the ALJ failed to consider what GAAS required of Grant Thornton in the circumstances presented by the Keystone audit. GAAS has detailed standards on planning and conducting an audit in light of identified internal control and fraud risks. FF 38–56. The mere existence of fraud and manipulation in the confirmation process, in and of themselves, therefore, could not relieve an auditor of its obligation to follow GAAS.

[16] There is no evidence of interference by Keystone management in connection with Grant Thornton's confirmation efforts directed to Advanta. In addition, the Comptroller accords no weight to the ALJ's citation (RD at 11) to a June 2000 errata to Ms. Church's deposition, stating: "UNB [United] owned 100% even though Advanta had confirmed to Susan Binger [sic] that Keystone owned them." OCC Ex. 541 at 000328. The deposition to which this errata pertains is not in the record and, equally as pertinent, the statement is hearsay and lacks any indication as to the time Ms. Church purportedly became aware of what Advanta supposedly told Ms. Buenger.

The fact that Grant Thornton was not retained to perform a "fraud" audit, as the ALJ found, therefore, is irrelevant. GAAS specifically requires *in every audit* that auditors assess the risk that the financial statements may be materially misstated due to fraud. FF 38, 47, 48. Grant Thornton found that this audit presented significant fraud risks and its expert, Mr. Jay Goldman, agreed. FF 166, 169. Although it may be true that auditing procedures may sometimes be ineffective for detecting some intentional misstatements (GT Exc. 210 (AU 230.12)), that does not excuse auditors from following heightened professional skepticism procedures when audit risk is at the maximum. In fact, GAAS requires greater scrutiny in such cases, not less. FF 38, 55, 57–60, 63.

The auditing experts for both parties (Mr. Harry Potter, who testified on behalf of E&C, and Mr. Goldman, who testified on behalf of Grant Thornton) agreed that, because the confirmation of Keystone assets reportedly serviced by third party servicers was "significant," GAAS required that Grant Thornton obtain *written* confirmation from Advanta that it was servicing the $242 million in loans that Keystone was reporting on its balance sheet. FF 70. In order to initiate the confirmation process, Grant Thornton sent a letter at the end of December 1998 to Advanta requesting that Advanta confirm in writing the Keystone loans it was servicing as of December 31, 1998 (the date of significance for purpose of the audit of loans reportedly owned by Keystone). FF 197. Believing that Advanta had failed to respond to Grant Thornton's request for written confirmation, Ms. Buenger, the Grant Thornton project manager assigned to this part of the audit, placed a telephone call in March 1999 to Ms. Patricia Ramirez, an account manager at Advanta, and was told by Ms. Ramirez that in early January 1999 Advanta had responded in writing to Grant Thornton's request for written confirmation. FF 198. Ms.

Buenger then faxed a copy of the confirmation-request letter that Grant Thornton had previously sent to Advanta and asked for another written response. FF 199. Advanta responded by sending Grant Thornton a copy of what had been mailed to Grant Thornton earlier. FF 200. Advanta's written response confirmed that, as of December 31, 1998, Advanta was servicing only $6.3 million in loans owned by Keystone under Investor No. 405 – not $242 million. FF 200.

On April 7, 1999, Ms. Buenger telephoned Ms. Ramirez about the Advanta confirmation. FF 202. Ms. Buenger testified that she asked Ms. Ramirez if there were any more Keystone loans and Ms. Ramirez indicated that Advanta was servicing more loans than had been identified in the written Advanta response. FF 202. Ms. Buenger testified that she then discussed with Ms. Ramirez the best way to get that information in writing and that they decided that Ms. Ramirez would send her an e-mail to that effect. FF 202. Within minutes of this conversation, Ms. Ramirez sent Ms. Buenger an e-mail that unequivocally stated that Advanta was servicing $236 million in loans *owned by United* under Investor No. 406. FF 203.

Contrary to the ALJ's suggestion (RD at 8) that the e-mail "confirmed a $236 million pool" owned by Keystone, the e-mail planly stated that the loans were *owned* by another bank, United. The e-mail did not mention Keystone.[17] FF 203. Ms. Buenger further testified that Ms. Ramirez never mentioned United in this telephone conversation (FF 205) and that she never asked Ms. Ramirez whether Advanta had two pools of Keystone loans. FF 206. Nonetheless, Ms. Buenger stated that she made a notation after the telephone conversation with Ms. Ramirez on a folder flap: "Per discussion with Patricia Ramirez at (619) 674-3876, the loans coded under the "United" name actually belonged to Keystone as of December 31, 1998." FF 214.

[17] Under the Advanta record system, the "investor" was the owner of the loans.

Ms. Ramirez testified through her deposition that, although she did not recall the telephone conversation, she simply would not have been confused about who owned the loans of Investor No. 406. FF 208, 209. She testified that she recalls sending e-mails to United and Keystone informing them of their respective investor numbers. FF 191. Moreover, she testified that she could not recall an instance when she had been confused about who owned loans in any particular file or an instance when loans were mis-coded. FF 209. She explained that it was her job as the accounts manager to know who owned the loans under any particular investor number. FF 210. Grant Thornton's expert, Mr. Goldman, testifying generally about his experience with third party servicers, confirmed that servicers are sophisticated and that a loan servicer is going to know what information is being sought because they respond to such requests all the time throughout each year. FF 211.

Ms. Buenger did not pursue or resolve with Ms. Ramirez or anyone else at Advanta the inconsistencies raised by this e-mail or the fact that the confirmation response indicated that Keystone owned only $6.3 million in loans. FF 212. Instead, even though the e-mail did not state that $236 million in loans were owned by Keystone, based upon Ms. Buenger's understanding of her telephone conversation with Ms. Ramirez, Ms. Buenger simply added the $236 million from Investor No. 406 (United) to the $6.3 million from Investor No. 405 (Keystone) and concluded that Keystone owned $242 million in loans being serviced by Advanta. FF 213.

According to the testimony of Mr. Potter, even if Ms. Buenger's version of the telephone conversation is credited and the notation on the folder was made contemporaneously with the telephone conversation with Ms. Ramirez, GAAS still required that Grant Thornton obtain

confirmation of Keystone's ownership of the loans in writing because of the significance of the dollar value of the loans in relation to total reported assets. FF 215. He explained that the written information obtained by Grant Thornton from Advanta not only indicated that only $6.3 million in loans was owned by Keystone, but also that $236 million in loans were not owned by Keystone. FF 216. Mr. Goldman, Grant Thornton's expert, agreed, stating that "there is no way that the e-mail in and of itself was a confirmation, because I think we'd all agree that it did not indicate the $242 million of loans that were on the books." Tr. 3113 (Goldman).

Such blind reliance upon an oral communication, contradicted immediately by a written communication, was not only a violation of GAAS's written confirmation requirement, but also constituted a violation of the auditor's responsibility to exercise "professional skepticism" in considering the competency and sufficiency of the evidence. FF 27. Moreover, had Grant Thornton understood the United/Keystone relationship, as required by GAAS, Ms. Buenger would have understood that Keystone and United were sharing information in order to execute the securitizations, and that Investor No. 406 contained United loans destined for future Keystone securitizations. Mr. Potter listed a number of ways in which Ms. Buenger could have requested clarification of the e-mail in writing, including sending a reply e-mail asking Ms. Ramirez to document in writing why loans coded as owned by United were, in fact, owned by Keystone. Tr. 2717 (Potter).

Even though Mr. Goldman agreed with Mr. Potter that GAAS required that the confirmation be in writing, Mr. Goldman testified at the hearing that Ms. Buenger was entitled to rely upon her understanding of the telephone conversation with Ms. Ramirez, because the telephone conversation was not an "oral confirmation." Instead, Mr. Goldman characterized the

telephone conversation as "support for the reconciliation between the written confirmation and what's on their books." Tr. 3109 (Goldman). Mr. Goldman's hearing testimony, however, contradicts his earlier deposition testimony, where he testified, consistent with Mr. Potter's hearing testimony, that the telephone conversation was, in fact, an oral confirmation. Tr. 3109, 3111–3112 (Goldman).

Mr. Goldman also asserted at the hearing that Ms. Buenger was entitled to rely upon Ms. Ramirez's e-mail as evidence that the loans described were owned by Keystone because Advanta had a policy of not sending information about one client to another client. Tr. 3111–3112 (Goldman). However, Mr. Goldman did not identify any applicable GAAS exception to the written-confirmation requirement that would support his assumption, and, moreover, there is no such exception. Further, given the Keystone/United arrangement, Keystone, of necessity, had access to United loan information and Advanta representatives knew that the two banks shared information. FF 207.

Also unpersuasive is the other evidence Grant Thornton offered to bolster the propriety of Ms. Buenger's conduct.[18] Ultimately, even Grant Thornton's expert, Mr. Goldman, acknowledged that in light of the $6.3 million confirmation response from Advanta, none of the evidence cited as supporting the conclusion that Keystone owned all of the $242 million in loans

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[18] Grant Thornton pointed to the following non-confirmation evidence: (1) a one-page forged Compu-Link remittance for December 1998 that was attached to a letter from a Compu-Link senior accountant, Mr. Forrest Krum, stating that "a detailed trial balance" was attached (OCC Ex. 295); (2) a letter from Mr. John LaRose, Compu-Link's chief executive officer, stating that, on December 17, 1998, Compu-Link transferred $242 million in loans to Advanta, as instructed (OCC Ex. 500); (3) a falsified schedule prepared by Keystone management showing Advanta servicing $242 million in Keystone loans (GT Ex. 1D); and (4) a conversation that took place sometime during January or February 1999 in which Keystone's attorney, a Mr. Lambert, made a comment about the transfer of loans from Compu-Link to Advanta (Tr. 2402 (Buenger)). None of this evidence wasconstituted the "sufficient competent evidential material" required by GAAS. (GT Ex. 206 (AU 150.02). *See* note 19, below.

being serviced by Advanta, was sufficient to comply with GAAS's written confirmation requirement because none of it was a response to a request to Advanta for written confirmation. Tr. 3104 (Goldman).[19]

C. Grant Thornton's Audit of Interest Income Reportedly Received in 1998 from Loans Serviced by Others Violated GAAS

For 1998, Keystone reported approximately $98 million of interest income from assets serviced by third parties specializing in servicing loans owned by other financial institutions. FF 218. The audit of this interest income was exceptionally important because it dwarfed any other number on the income statement. FF 218. Because Keystone did not own $236 million of the $242 million in loans the bank claimed were being serviced by Advanta (and did not own the approximately $227 million in loans the bank claimed were being serviced by Compu-Link), Keystone received almost none of the reported $98 million in interest income.

In auditing Keystone's reported interest income, Grant Thornton employed an analytical test, called a "test of reasonableness." FF 179. This test simply compared the reported income to the dollar amount and the characteristics of reported loans in order to determine if the reported income was "reasonable." FF 180. E&C charged that the "test of reasonableness" violated

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[19] This evidence is inadequate for other reasons. The attachment to the Krum letter is a remittance – not "a detailed trial balance" as stated in the accompanying letter. The LaRose letter does not state that Keystone owned the loans that were transferred from Compu-Link to Advanta, all $242 million of these loans ($236 million belonged to United) were acquired in anticipation of a 1998 Keystone securitization (which almost exclusively used loans owned by United), and the transfer took place for reasons related to Keystone's securitization program (Compu-Link lacked the Wall Street rating desired by the Keystone's securitization counsel). Grant Thornton was not permitted by GAAS to rely upon the "lead sheet" prepared by Keystone management because it knew Keystone's internal controls were unreliable and Grant Thornton had not independently verified the data for accuracy. Finally, the conversation with Mr. Lambert obviously was not in writing, did not discuss the number of loans or the dollar value of the loans transferred, and, as was the case with respect to the LaRose letter, had Grant Thornton understood the Keystone/United securitization program, Grant Thornton would not have been misled into believing that all of the transferred loans belonged to Keystone. GT also relied upon an "electronic bulletin board download," but Ms. Buenger did not log onto the system, did not pull up the data observed, the data was not as of December 31, 1998, and she acknowledged that this information was not a confirmation. Tr. 2400–2401 (Buenger).

GAAS because GAAS required a "test of details" under the circumstances. A "test of details" refers to a substantive test that reviews primary financial documents including, but not limited to, remittances, wire transfers and cash receipts. FF 64. Simply put, a "test of details" involves looking at specific transactions whereas an analytical test seeks to compare the relationships of entries to the financial statements themselves. FF 64, 66.

1. GAAS Required a "Test of Details"

The ALJ excused Grant Thornton's failure to conduct a "test of details" because Ms. Buenger had "overall concerns about the [bank's] records." RD at 14. "The problem with a test of details at Keystone was that many documents were fabricated." RD at 14. The fact that an auditor may have concerns about an entity's internal controls and the accuracy of its accounting data, however, does not mean that the auditor can blindly rely upon financial data provided by the very management that has created such concerns. In such circumstances, GAAS requires greater "professional scrutiny" – not less. FF 22–28, 40, 54. When an auditor lacks confidence in the internally generated data, GAAS requires that an auditor independently review primary financial documents such as remittances, wire transfers and cash receipts in order to assure that the entity is actually receiving the reported income. FF 235.

There is no dispute that GAAS, under the circumstances of the Keystone audit, required Grant Thornton to conduct a "Comprehensive" audit, as described in Grant Thornton's audit manual. FF 160. Nevertheless, Grant Thornton performed only analytical tests in auditing interest income for loans serviced by third parties, even though GAAS requires that in a maximum risk audit auditors should primarily rely upon a "test of details" for auditing both the

balance sheet (asset ownership) and the income statement (income on loans serviced by others). FF 160.

In spite of this clear statement of what GAAS required under the circumstances of the Keystone audit, Grant Thornton relied at the hearing upon a qualifying statement in its auditing manual, which purports to follow GAAS, to the effect that an analytical test could be used in place of a "test of details" if the analytical test was "very strong." FF 160. Although the ALJ agreed with Grant Thornton, her conclusion was incorrect because there is no dispute that, for purposes of determining whether Grant Thornton engaged in an unsafe or unsound practice, Grant Thornton's audit manual does not and cannot trump the standard of care set by GAAS. Under GAAS, an analytical test could be used as a substantive test in place of a "test of details" *only* (1) where potential misstatements would not be apparent from an examination of the detailed evidence or (2) where detailed evidence is not readily available. FF 67, 228.

As Mr. Potter testified, in the circumstances of this audit, reliance upon an analytical test (the "test of reasonableness") was inappropriate because neither of the two conditions identified in AU § 329.12 was present.[20] FF 67, 228. With respect to the first condition, the bank's interest income would have been apparent from an examination of the detailed evidence, and, with respect to the second condition, this evidence was readily available. FF 227, 228. Grant Thornton would have had to review only twelve monthly Compu-Link remittances and track the cash into the bank's records, because most of the loans reportedly serviced by third party servicers in 1998 were supposedly serviced by Compu-Link. FF 260. Indeed, in August 1999,

[20] OCC Ex. 781 (AU 329.12) ("Analytical procedures may be effective and efficient tests for assertions in which potential misstatements would not be apparent from an examination of the detailed evidence or in which detailed evidence is not readily available.").

when the fraud was uncovered, that is precisely what Grant Thornton auditors did in an effort to prove to the OCC examiners that Keystone had, in fact, received the income Grant Thornton's audit purported to verify. FF 258. In less than an hour, Grant Thornton's August 1999 review demonstrated that Keystone had not received the $98 million in reported income because it did not own the loans. FF 226. This is also the same procedure that the lead auditor, Mr. Quay, used during the audit to verify Keystone's correctly reported interest income related to its residual assets. FF 223.

2. The Analytical Test Based Upon Bank Generated Documents and Call Reports Did Not Satisfy GAAS

The ALJ concluded that:

> GAAS and Grant Thornton's manual did not require a test of details. OCC's expert testified that the manual, which complied with GAAS, permitted "very strong" analytical procedures for a maximum risk audit.

RD at 15. The ALJ then found, based on Ms. Buenger's testimony, that the "test of reasonableness" used by Grant Thornton was "very strong" because Grant Thornton had obtained asset confirmations from third party servicers. RD at 15.

As an initial matter, an analytical test for verification of interest income, within the plain terms of Grant Thornton's manual, cannot be "very strong" simply because a "test of details" was performed in the verification of asset ownership. The three types of audit strategies in Grant Thornton's audit manual must be read together. FF 158–160. In an "Analytical" audit, "tests of details" can be minimized or eliminated because environmental factors, accounting systems and control procedures "are sufficiently strong to allow us to accept maximum detection risk." FF 158. A "test of details" in an analytical audit is performed only on those items that warrant

detailed examination. FF 159. A "Basic" audit, the second of the three audit strategies, usually requires analytical procedures to be augmented with "tests of details" only because the internal controls have not been exhaustively tested, although they have been tested sufficiently to believe that they are generally reliable. FF 159. In a maximum risk "Comprehensive" audit, the manual states that, because "environmental factors, accounting systems or control procedures are sufficiently weak to cause the possibility of a material misstatement occurring in the related financial statement account to be high," the auditors are to "concentrate on tests of details for both balance sheet and income statement accounts." FF 160. Under this scheme, if Grant Thornton auditors in the context of a maximum risk "Comprehensive" audit, could dispense with a "test of details" in verifying income just because they had performed a "test of details" in verifying assets on the balance sheet, there would be no meaningful distinction between a "Comprehensive" audit and a "Basic" audit.[21]

Although Grant Thornton's manual states in describing the "Comprehensive" audit strategy that "very strong" analytical procedures may be used to provide "substantive evidence," even though the auditors are instructed to concentrate on "tests of details," Mr. Potter testified that the results of the analytical procedures employed by Grant Thornton did not qualify as "substantive evidence" and the analytical procedures were not "very strong." FF 244. Because Grant Thornton used a "test of reasonableness" that did not provide "substantive evidence" (FF 246), it violated *both* GAAS and its manual. In other words, even assuming, *arguendo*, that

[21] *Compare* Basic Audit ("This strategy generally emphasizes analytical procedures on income statement accounts and tests of details, on a reduced scope basis, for balance sheet accounts.") and Comprehensive Audit ("[T]his strategy generally concentrates on tests of details for both balance sheet and income statement accounts. If analytical procedures are performed for the purpose of providing substantive evidence, they are generally proof-in-total or other very strong analytical procedures."). OCC. Ex. 327 at GT 012344.

the Grant Thornton manual, and not GAAS, is the standard of adequacy, Grant Thornton's conduct of the audit in this case failed that standard.

The "test of reasonableness" utilized by Grant Thornton was not a substantive test because the financial data upon which it was based was wholly unreliable. FF 232–243. Before an analytical test can provide substantive evidence under GAAS, GAAS requires the auditor to assess the reliability of the data upon which the test depends by considering the following factors: (1) whether the data was obtained from independent sources outside the entity or from sources within the entity; (2) whether sources within the entity were independent of those who are responsible for the amount being audited; (3) whether the data was developed under a reliable system with adequate controls; (4) whether the data was subjected to audit testing in the current or prior year; and (5) whether the expectations were developed using data from a variety of sources. FF 68. All of these factors indicated that the information obtained from Keystone management for the "test of reasonableness" was unreliable. Accordingly, although the ALJ was correct that Mr. Potter testified that in certain circumstances GAAS permitted the use of "very strong" analytical tests to provide substantive evidence (circumstances, as discussed above, not present here) and even assuming that Grant Thornton's audit manual generally fulfilled its obligation to provide guidance to its auditors concerning GAAS compliance, the "test of reasonableness" employed by Grant Thornton was neither substantive nor strong.[22] FF 243–244.

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[22] GAAS provides that the internal controls of the entity being audited must be tested for reliability before an analytical test may be used as substantive evidence. AU 312.16; AU 312.17; AU 326.11, 326.13; AU 319.03, 319.05; *see also* OCC Ex. 296 at GT/F 00529; OCC Ex. 327 at GT 012344 (importance of internal controls systems to analytical tests).

Because, as Grant Thornton was aware, Keystone's internal controls and accounting data were unreliable, both experts agreed that GAAS required that Grant Thornton test for accuracy all financial data provided by Keystone's management. Tr. 2729-30 (Potter); Tr. 3058 (Goldman). Grant Thornton's expert, Mr. Goldman, even testified that "if you are not relying on controls and you ask the client to prepare a schedule, regardless of the circumstances, even if it's a well-controlled bank, you know, the auditor has a responsibility to go back and evaluate it and compare it to the company records." Tr. 3058 (Goldman). Ms. Buenger admitted that Grant Thornton did not test for reliability any of the financial data that management provided her during the interest-income testing phase, including Keystone's schedule prepared by Mr. Graham and the bank's Call Reports. FF 236.

Despite the unreliability of Keystone's internal controls and Grant Thornton's failure to independently verify all financial data provided by Keystone management for use in the analytical test, Ms. Buenger still believed the "test of reasonableness" was "very strong" "because there is a normal correlation between the loan portfolio and the interest income that is earned on a loan portfolio." Tr. 2409 (Buenger). However, as Mr. Potter noted, if the income data used in the "test of reasonableness" has been manipulated, the "normal correlation" will exist only because that is what the manipulator desired – not because it actually exists. FF 229.

3. The Analytical Test Based upon the December 1998 Remittance Deviated from GAAS in Several Respects

Ms. Buenger testified that, because she had concerns about the reliability of the "test of reasonableness" based upon the Graham schedule and the Call Reports, she conducted a second "test of reasonableness" based upon a purported Compu-Link remittance for December 1998.

FF 247. She testified that she obtained the fraudulent December 1998 remittance from an employee of the bank, named Ms. Watkins, but could not remember whether she asked for it specifically to conduct the test or just saw it on a chair in Ms. Watkins's office. FF 246.

The use of the purported December 1998 Compu-Link remittance violated GAAS for several reasons. First, GAAS required that the interest income stated in the purported December 1998 remittance be tracked into the bank's records in order to make sure that the reported monthly income of $10 million was actually received by Keystone. Tr. 2874-76 (Potter). Grant Thornton did not do this.

Second, reliance upon the purported remittance violated GAAS's requirement that auditors maintain appropriate skepticism. The remittance, a one-page document, was attached to a one-line letter from Mr. Krum, a Compu-Link accountant. It stated: "Enclosed please find a detailed trial balance for the month ending December 31, 1998. The payments received in December 1998 have been forwarded to you." FF 247. There is no dispute that a one-page remittance – not "a detailed trial balance" – was attached to the Krum letter. In addition, the remittance was not on Compu-Link letterhead and did not indicate that Compu-Link generated it. FF 252. Ultimately, Ms. Buenger admitted that she never saw the trial balance (which would have been a voluminous document) associated with this letter, and she did not ask Ms. Watkins or anyone else for the trial balance that was supposedly attached. FF 248, 249.

Professional skepticism should have prompted Ms. Buenger to ask the client or Compu-Link why the body of the letter did not match the attachment, why the trial balance was not attached, why the remittance was not on Compu-Link letterhead, or what prompted Compu-Link to send the letter. FF 28. Auditors are not trained to recognize forgeries. FF 30. Nor are they

held liable as an IAP solely because they may fail to uncover a fraud. FF 30. However, in auditing the financial statements of an insured depository institution, they are required, at a minimum, to comply with GAAS. In the circumstances of the Keystone audit, which presented a maximum audit risk, GAAS did not permit Ms. Buenger to accept the Krum letter and purported attachment uncritically at face value. FF 28.

Third, the methodology Ms. Buenger employed for the test does not comport with the obligation of an auditor to obtain "[s]ufficient competent evidential matter . . . through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." FF 16. In performing the "test of reasonableness," Ms. Buenger took the December 1998 interest income figure and annualized it in order to estimate Keystone's total 1998 interest income from loans serviced by third party servicers over the other eleven months of 1998. FF 245. The underlying assumption in using one month's interest income to calculate Keystone's interest income for the year was that Keystone's assets and income over the course of 1998 were approximately the same as they were for December 1998. This assumption would be incorrect, however, in the event Keystone was using *its own* loans for the two securitizations that it executed in 1998, as Grant Thornton's workpapers assumed.

Grant Thornton believed that Keystone used its own loans to execute two large securitizations in 1998 – one in May and one in September. FF 120. Because Grant Thornton believed Keystone was using its own loans in these securitizations (a total of approximately $500 million), Grant Thornton should have expected loan build-ups prior to each securitization and drop-offs in loans owned by Keystone following each securitization. But Ms. Buenger's second

"test of reasonableness" used the purported December 1998 interest income to derive an annualized income for the year, and assumed relatively steady income from a relatively steady asset base for the entire twelve months. This methodology was exactly contrary to Grant Thornton's assumption that Keystone was using its own loans for the securitizations. In short, Grant Thornton's belief that Keystone used its own loans in the two securitizations, totaling approximately $500 million, should have precluded its annualization of income based upon one-month's interest income.

II. GRANT THORNTON "RECKLESSLY" PARTICIPATED IN UNSAFE OR UNSOUND PRACTICES

To hold Grant Thornton accountable as an IAP, it is not enough to establish that Grant Thornton participated in an unsafe or unsound practice. An auditor does not become an IAP, under 12 U.S.C. § 1813(u), simply by failing to comply with the technical requirements of GAAS. The auditor's conduct, in failing to comply with GAAS, must demonstrate something more. As the Second Circuit observed in *Cavallari,* 57 F.3d at 142, in order to be an IAP, Grant Thornton in planning and conducting the audit must have acted "in disregard of, and evidencing conscious indifference to, a known or obvious risk of a substantial harm."

Based upon a review of the entire record, Grant Thornton's conduct demonstrated a disregard of, and evidenced a conscious indifference to, a known or obvious risk of a substantial harm, under *Cavallari*. In the context of an acknowledged maximum risk audit, an auditor acts with disregard of and conscious indifference to a known or obvious risk of substantial harm when the auditor fails to follow GAAS's heightened scrutiny requirements and fails to execute fundamental and important procedures required by GAAS. To ignore those requirements and

procedures in the planning, staffing, and execution of an audit of the most material and significant entries in the financial statements of an insured depository institution under the circumstances of this case constitutes recklessness within the meaning of 12 U.S.C. §§ 1813(u) and 1818(i)(2)(B)(II).[23]

The ALJ concluded that, because Keystone management acted fraudulently, Grant Thornton was not reckless in carrying out the audit. RD at 15. Contrary to the ALJ's reasoning, and as discussed above, the fact that fraud exists and management is intent upon undermining the audit does *not* excuse the failure of auditors to follow GAAS in auditing two of the most significant entries on the financial statements. GAAS requires that, during the planning phase of an audit as well as during the audit itself, auditors evaluate the risks that the financial statements may be misstated whether caused by fraud or error.

With respect to Grant Thornton's verification of Keystone's interest income, the ALJ observed that, although Ms. Buenger did not know that Keystone management was fabricating documents, she did know that there were overall concerns about the bank's records. RD at 14. From this premise, the ALJ concluded that "[b]ecause of this, Buenger was not reckless in relying on third party verification and reasonableness tests, rather than a test of details." RD at 14. However, to conclude (as the ALJ did) that a "test of details" was not required by GAAS because the auditor had concerns about the integrity of management and the bank's accounting records turns GAAS on its head.

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[23] Although Grant Thornton does not except to the ALJ's conclusion that it did not act recklessly in conducting the audit, Grant Thornton argues in its exceptions that the OCC and FDIC examiners' review of the audit workpapers and failure to discover any GAAS irregularities require a conclusion that Grant Thornton was not reckless. GT Ex. at 23-24. However, as Grant Thornton acknowledges, these examiners were not auditors and they were not reviewing Grant Thornton's workpapers for evidence of compliance with GAAS. *Id.* at 23.

Auditors participate in a "public practice" and owe an "obligation of fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors." FF 11.[24]

A. Grant Thornton "Recklessly" Failed to Comply with GAAS by Not Conducting a Comprehensive Audit with a Test of Details

Although Grant Thornton claims that it planned and conducted a "Comprehensive" audit consistent with its conclusion that the Keystone audit presented maximum audit risk, a review of the entire record demonstrates that Grant Thornton, instead, appears to have planned and conducted a "Basic" audit in violation of GAAS. Tr. 2751-52 (Potter). If Grant Thornton had planned for and conducted a "Comprehensive" or maximum risk audit, it would have relied primarily upon a "test of details" for auditing the interest income of assets reportedly serviced by others and properly obtained *written* confirmation when conducting the "test of details" for auditing the assets themselves. This would have been consistent with GAAS. Use of these procedures would have significantly increased the likelihood that the audit would have detected the true condition of the bank.

Grant Thornton prepared an audit plan for Keystone that called for only an analytical procedure (a "test of reasonableness") with respect to interest income, instead of a "test of details." Nearly all of Grant Thornton's audits were "Basic" audits and the "test of

[24] Grant Thornton urges the Comptroller to reject the ALJ's finding that the OCC could not disclose non-public information relevant to audit risk, such as criminal referrals of bank management and to "rule that the OCC should have shared with Grant Thornton information regarding management integrity issues." GT Exc. at 24-27; RD at 22, ¶ 41. However, contrary to Grant Thornton's urging, the Comptroller adopts this finding of the ALJ, because, as the ALJ found, the OCC shares adverse information through its ROEs, which Grant Thornton reviewed. Through this vehicle, Grant Thornton was well aware that the OCC had serious concerns about the integrity of Keystone management. And, indeed, Grant Thornton concluded that this was a maximum risk audit.

reasonableness" was the "standard format" used by Grant Thornton. FF 183. In fact, Ms. Buenger always used the "test of reasonableness" to test interest income. FF 183.

By the time Mr. Quay signed off on the audit plan in mid-January 1999 (FF 184), however, Grant Thornton had identified the Keystone audit as presenting "maximum" risk that required a "Comprehensive" audit. FF 184, 185. Despite the "maximum" risk assessment, the audit plan itself was never altered, and Grant Thornton conducted a "Basic" audit. Grant Thornton's failure to conduct a maximum risk audit as required by GAAS in the maximum risk environment Grant Thornton knew to exist evidenced disregard of a known or obvious risk of substantial harm to the users of Grant Thornton's audit reports, or a conscious indifference to that risk.

B. Under the Circumstances, Grant Thornton "Recklessly" Relied upon a Conversation with an Advanta Representative

Grant Thornton acted recklessly in violating GAAS by failing to obtain written confirmation of the assets owned by Keystone and serviced by Advanta. In a maximum risk audit, relying upon an oral confirmation to verify ownership of approximately 25 percent of an entity's reported assets evidenced a disregard of a known or obvious risk of a substantial harm, or evidenced a conscious indifference to that risk. *Cavallari*, 57 F.3d at 142. The quantitative materiality of $242 million is the very reason why GAAS requires the confirmation to be in writing.

Under the circumstances of this audit, however, Grant Thornton's actions were particularly egregious and reckless. Here, Grant Thornton relied upon oral evidence even though it had received unequivocal, written evidence – in the form of a formal written response to a confirmation request – that Advanta was servicing only a small fraction ($6.3 million) of the

$242 million in loans Keystone was reporting. Moreover, the oral evidence concerning the servicing of additional Keystone loans was unambiguously contradicted almost immediately by Grant Thornton's later receipt of an e-mail from Advanta. These two written sources of evidence not only failed to confirm what Keystone was reporting, they also flatly evidenced that Keystone did *not* own nearly all of the loans it was reporting. Nevertheless, in violation of GAAS, Grant Thornton opted to rely upon the oral communication. Reliance upon Ms. Buenger's understanding of an oral communication (even if fully credited) demonstrated a disregard of, or conscious indifference to, the known or obvious risk of a substantial harm that could result to those who relied to their detriment upon assertions in Keystone's financial statements concerning the assets owned by the bank.

C. Grant Thornton "Recklessly" Failed to Comply With GAAS When It Used Analytical Procedures to Test Interest Income

Grant Thornton's use of an analytical "test of reasonableness" for income was reckless because it violated GAAS under circumstances in which Grant Thornton knew that Keystone's internal controls were unreliable and that it could not rely upon internally generated accounting data. Despite this, Grant Thornton recklessly relied on that data without testing Keystone's internal controls or independently verifying the data obtained from Keystone management in total disregard of the risks its actions posed. *Cavallari*, 57 F.3d at 142.

Grant Thornton's conduct, however, evidences even greater recklessness. Not only did Grant Thornton fail to check the accuracy of the data on the Graham schedule, but it also used data from the schedule in its "test of reasonableness" on interest income even though it was aware that at least some of the data in the schedule was inaccurate. Even if Grant Thornton did not know that the precise data points from the schedule that it used were inaccurate, it knew that

the schedule, in fact, contained erroneous data. FF 237. As Ms. Buenger acknowledged, if the data in the schedule was incorrect, the test results would be unreliable. FF 242. Grant Thornton's actions demonstrated a disregard of, or conscious indifference to, the known or obvious risk of a substantial harm that could result from its failure to follow GAAS.

D. Grant Thornton Recklessly Ignored Its Obligation To Understand Keystone's Securitization Process

Grant Thornton's audit manual well summarized GAAS when it stated that "[k]nowledge of the client's business is critical to our overall client relationship and is a key element of our planning procedures. Knowledge of the client's business . . . is key to the determination of critical transaction cycles and assertions." FF 116. Grant Thornton's audit manual addresses GAAS's requirement that the auditor:

> obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements.

FF 19. This obligation was critical and key because an understanding of a client's principal operating characteristics increases the auditor's ability to identify material misstatements in the financial statements. Grant Thornton's conduct in connection with the use of the December 1998 remittance attached to the Krum letter for verifying interest income and its failure to obtain written confirmation of the Keystone assets serviced by Advanta demonstrates Grant Thornton's reckless indifference to this obligation as it related to Keystone's securitization business.

Despite the importance of understanding the operational characteristics of Keystone's securitization process, Ms. Buenger testified that she did not believe it was important for her to

understand Keystone's securitizations because "that was Mr. Quay's responsibility." FF 125. Ms. Buenger further testified that she was not even aware of the relative size of Keystone's two 1998 securitizations and, in fact, did not know the source of $500 million in securitized loans. FF 125. This testimony is especially remarkable given that Grant Thornton prepared a memorandum prior to the audit describing its (incorrect) understanding that Keystone owned the loans it was transferring to securitization trustees at the time of each securitization. FF 122. Mr. Quay, as the lead auditor, had an obligation under GAAS to supervise Ms. Buenger and to make her aware of the importance of Keystone's securitization process to her audit responsibilities, even if Ms. Buenger, herself, did not think it was important. FF 24. Grant Thornton's disregard of the importance of Keystone's securitization program to the verification of Keystone's reported interest income from loans serviced by servicers demonstrated a violation of GAAS and a disregard of, or conscious indifference to, the known or obvious risk of a substantial harm that could result to those who relied to their detriment upon assertions in Keystone's financial statements.

III. GRANT THORNTON ACTED AS AN "INDEPENDENT CONTRACTOR"

Grant Thornton excepts to the ALJ's conclusion that Grant Thornton, as a firm, can be an "independent contractor" within the meaning of the statute defining an IAP. GT Exc. 7–11; *see* 12 U.S.C. § 1813(u)(4). Grant Thornton contends that the term encompasses only individuals, not firms. The ALJ, however, properly found that the term – "any independent contractor" – unambiguously applies to both firms and entities. The Comptroller agrees with the conclusion of the ALJ. In addition, the interpretation of the ALJ is supported by the circumstances of this case and relevant legislative history. Indeed, according to the FIRREA Conference Report, Congress

intended that "the new term [IAP] . . . broaden[] the group of individuals *and entities* covered." Conf. Rep. No. 101-222 at 439 (emphasis added).

IV. THE AUDIT FAILURE CAUSED "MORE THAN A MINIMAL FINANCIAL LOSS"

The ALJ concluded that Grant Thornton's audit opinion helped Keystone to remain open and to incur additional losses. RD at 7. Further, the ALJ concluded that the audit opinion facilitated the payment of over $1 million in dividends that was made after the opinion was issued, and that the dividend payments caused more than a minimal financial loss to, and had a significant adverse effect upon, Keystone. RD at 7. Finally, the ALJ rejected Grant Thornton's argument that because Keystone's residual assets increased in value between the time the opinion was issued and the time the bank was closed Keystone was not harmed. RD at 7.

In its exceptions, Grant Thornton argues that once a corporation reaches the point of insolvency, the corporation cannot suffer any additional losses. GT Exc. at 15-16. The Comptroller disagrees. At the point of insolvency (which the parties agree was no later than 1996) the creditors and the FDIC deposit insurance fund have an economic interest in the value of the corporation, and, accordingly, management owes a duty to them not to aggravate the entity's insolvency. *See Pereira v. Farace*, 413 F.3d 330, 342 (2nd Cir. 2005), *cert. denied*, 126 S. Ct. 2286 (2006). Accordingly, by facilitating the payment of over $1 million in dividends to shareholders – who at the point of insolvency ceased to have an economic stake in the corporation – Grant Thornton harmed the bank's creditors and the FDIC because it deepened the bank's insolvency.

Grant Thornton also argues that E&C failed to prove that the audit opinion "caused" more than a minimal financial loss to, or a significant adverse effect upon, the bank. GT Exc. at 19-20.

Again, the Comptroller disagrees. Grant Thornton's unsafe or unsound audit was the proximate cause of the loss the bank suffered due to the dividend payments. An auditor cannot avoid responsibility as an IAP by arguing that it is the financial institution's actions that are the "cause" of the loss. First, 12 U.S.C. § 1813(u)(4) covers conduct that "caused or is likely to cause" more than minimal financial loss, or a significant adverse effect on, the bank. Even if the word "caused" could be limited as Grant Thornton argues, Grant Thornton's conduct still would be "likely to cause" more than a minimal financial loss to the bank, because GAAS is designed to protect users of audited financial statements increasing the likelihood that auditors will identify material misstatements whether caused by error or fraud. Tr. 2725 ("following GAAS would have uncovered the fraud at Keystone"), 2927 (Potter).

Under the circumstances of this case, had Grant Thornton followed GAAS, it probably would not have issued the unqualified opinion. This is established by how quickly the true financial condition of the bank was uncovered when the proper procedures were followed. Second, under Grant Thornton's theory, conduct of independent contractors could never be a cause of a loss or other adverse effect for purposes of 12 U.S.C. § 1813(u)(4), because it would always be the financial institution's acts or omissions that led to the loss to, or adverse effect on, the bank. Such a result would defeat the intent of Congress in extending enforcement authority to auditors of insured financial institutions.[25]

[25] *See* Discussion, Subpart I, above.

V. STANDARDS AND BASES FOR THE ADMINISTRATIVE ACTIONS

A. Action for Civil Money Penalty

The Comptroller finds that the CMP of $300,000 that the OCC assessed against Grant Thornton is justified pursuant to 12 U.S.C. ' 1818(i)(2)(B). The OCC assessed this second tier CMP, finding that Grant Thornton's conduct more than satisfied the statutory requirements that: (1) the IAP must have violated any law, regulation or final cease and desist order *or* recklessly engaged in an unsafe or unsound practice in conducting the affairs of the insured depository institution *or* breached a fiduciary duty; and (2) the violation, practice or breach was part of a pattern of misconduct *or* caused or was likely to cause more than a minimal loss to such depository institution *or* resulted in pecuniary gain or benefit to such party. Based on the record and findings that Grant Thornton is an IAP, it is clear that Grant Thornton satisfies each element for imposition of a second tier CMP.

In determining the appropriate amount of a CMP, the Comptroller is required to consider certain factors specified in 12 U.S.C. ' 1818(i)(G). Specifically, the OCC must consider "(i) the size of the financial resources and good faith of the insured depository institution or other person charged; (ii) the gravity of the violation; (iii) the history of prior violations; and (iv) such other matters as justice may require." 12 U.S.C. § 1818(i)(G). The Comptroller's decision above, which includes the Findings of Fact and Conclusions of Law contained in Appendix A, establish the appropriateness of the second tier $300,000 CMP.

Although specific evidence of Grant Thornton's net worth is not reflected in the record, the evidence establishes that Grant Thornton, a national accounting firm, is the fifth largest accounting firm in the United States, with three hundred partners, 3,500 employees, and 40

offices. Moreover, Grant Thornton received over $500,000 in fees (including $150,000 for its audit of Keystone's 1998 financial statements) in connection with its Keystone engagement. Accordingly, the Comptroller concludes that Grant Thornton has sufficient resources to pay a $300,000 CMP.

With respect to mitigation where the respondent has acted in "good faith," Grant Thornton's disregard of, or conscious indifference to, the known or obvious risk of the substantial harm that could result to the bank and those who relied to their detriment upon assertions in Keystone's financial statements precludes mitigation on this basis, particularly in light of its disregard of the OTS Order.

In considering the gravity of the offence, the Comptroller has considered evidence establishing that Grant Thornton repeatedly deviated from GAAS in planning and conducting the audit of Keystone's assets and income. Although the Comptroller recognizes that the fraud perpetrated by Keystone officers and directors played a role in the ultimate failure of the bank, Grant Thornton's unqualified audit opinion, stating that Grant Thornton had obtained reasonable assurance that the bank's 1998 financial statements were not materially misstated and were prepared in accordance with GAAP and audited in accordance with GAAS, enabled the bank to remain in business and incur additional losses, including the payment of approximately $1 million in dividends, thereby deepening the bank's insolvency. Accordingly, under the circumstances of the audit, Grant Thornton's laxity in planning and conducting its audit of Keystone was egregious.

The Comptroller has also considered Grant Thornton's history of prior violations. The Comptroller notes that at the time that Grant Thornton planned and conducted its audit of

Keystone it was operating under the terms of the OTS Order. The OTS had initiated its enforcement action to address, among other matters, the failure of Grant Thornton's predecessor to follow GAAS in conducting its audit of an insured depository institution that suffered large losses and was closed. The fact that Grant Thornton was under a regulatory order imposing specific requirements on its audits of insured depository institutions, including the requirement to follow GAAS, when it audited Keystone is significant evidence that supports the imposition of the CMP sought by the OCC. Indeed, Grant Thornton's failure to follow scrupulously the dictates of what GAAS and the OTS Order required in planning and conducting its audit of Keystone is remarkable.[26] Accordingly, considering all relevant factors, including the gravity of Grant Thornton's offence, financial ability to pay the assessment, and previous violations, the Comptroller orders Grant Thornton to pay a $300,000 CMP.

B. Cease and Desist Action

Section 1818(b)(1) of title 12 provides, in pertinent part, that the appropriate Federal banking agency may issue a C&D against an IAP who engaged in an unsafe or unsound practice or who has violated a law, rule or regulation. For the reasons discussed above and established in the record, Grant Thornton is an IAP. The findings above that Grant Thornton participated in an unsafe or unsound practice also establishes the basis for issuing a C&D. The Comptroller, therefore, in a separate Order, imposes a C&D on Grant Thornton addressing Grant Thornton's provision of audit and accounting services to insured depository institutions for six years from the effective date of that Order.

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[26] The OTS Order was in effect until 2001 and required Grant Thornton in connection with the planning of any audit of an insured financial institution to test "internal controls for the purpose of determining the nature, timing, and extent of substantive tests to be performed." FF 5–7.

VI. OTHER MATTERS PENDING BEFORE THE COMPTROLLER

With respect to Grant Thornton's motion for oral argument before the Comptroller, the arguments in support of its motion are unpersuasive, and, accordingly, the motion is denied.

ORDER

Based upon the entire record of the proceeding, the pleadings, the ALJ's RD, Exceptions to the RD filed by both Grant Thornton and E&C, and for the reasons set forth in the accompanying decision, the Comptroller, pursuant to his authority under 12 U.S.C. ' 1818, orders Grant Thornton to pay a civil money penalty in the amount of $300,000 and imposes a Cease and Desist Order that will be issued separately.

Respondent=s request for an in-person hearing is denied.

IT IS SO ORDERED, this 7th day of December, 2006.

/s/

JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF:	)	**APPENDIX TO**
Grant Thornton LLP	)	**FINAL DECISION**
External Auditor For	)	**AA-EC-04-02**
The First National Bank of Keystone	)	**AA-EC-04-03**
Keystone, West Virginia	)	

Appendix A

Findings of Fact and Conclusions of Law

The Comptroller accepts the recommended Findings of Fact of Administrative Law Judge Ann Z. Cook ("ALJ") only to the extent that they are not inconsistent with the foregoing decision and findings of fact set forth below. The Comptroller accepts the ALJ's recommended conclusions of law numbered 1 and 2, and rejects recommended conclusion of law number 3.

Findings of Fact

A. OCC, Keystone, and Grant Thornton

1. The former First National Bank of Keystone, Keystone, West Virginia ("Keystone" or "bank"), was a national bank and an "insured depository institution." 12 U.S.C. § 1813(c)(2); Tr. 87-88 (Schneck).

2. The Office of the Comptroller of the Currency ("OCC") is the "appropriate Federal banking agency" to initiate and maintain an enforcement proceeding against an "institution-affiliated party" ("IAP") of the bank. 12 U.S.C. § 1813(q)(1).

3. Grant Thornton LLP ("Grant Thornton"), a limited partnership, provides accounting services throughout the United States, and has approximately 40 offices, 300 partners and 3,500 employees. Tr. 2160 (Quay); *see also* OCC Ex. 286 at 7.

4. Grant Thornton is the fifth largest auditing firm in the United States. Tr. 1926 (Quay).

5. On October 3, 1996, Grant Thornton agreed to settle a cease and desist order ("OTS Order") with the Office of Thrift Supervision ("OTS") in connection with the provision of accounting and auditing services by Grant Thornton's predecessor to San Jacinto Savings Association, Bellaire, Texas. OCC Ex. 4.

6. The OTS Order provided, in part, that:

> The risk assessment [related to planning each audit] shall include an assessment of the risk that errors and irregularities may cause the financial statements to contain a material misstatement and, based on that assessment, Grant Thornton shall design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements in accordance with SAS No. 53 (AU § 316) [titled "Consideration of Fraud in a Financial Statement Audit]. The risk assessment also shall include obtaining an understanding of the institution's internal control structure . . . . The audit plan shall include the plan for identifying and testing internal controls for the purpose of determining the nature, timing, and extent of the substantive tests to be performed.

OCC Ex. 4 at 6.

7. The OTS Order was to remain in effect for five years, and, at the time that Grant Thornton planned and conducted its audit of Keystone, it was operating under the terms of the OTS Order. OCC Ex. 4 at 2, 18.

8. Grant Thornton commenced its audit work at Keystone in August 1998. Tr. 1953–1954 (Quay); Tr. 2324 (Buenger).

9. By the time Keystone was placed into receivership in September 1999, Grant Thornton had billed Keystone for approximately $500,000 in fees related to the 1998 audit and other accounting services. Tr. 1954–1955 (Quay); OCC Ex. 286 at 28; OCC Ex. 786 at 1, 4.

10. Grant Thornton commenced the audit of Keystone's 1998 financial statements in late December 1998. Tr. 1953–1954 (Quay); Tr. 2333–2334 (Buenger).

B. Generally Accepted Auditing Standards

1. The GAAS Framework

11. Auditors participate in a "public practice" and owe an "obligation of fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors." GT Ex. 209 (AU 220.02); Tr. 2685 (Potter); Tr. 2976 (Goldman).

12. Generally Accepted Auditing Standards ("GAAS") are promulgated by the American Institute of Certified Public Accountants ("AICPA"). GT Ex. 206 (AU 150.02).

13. AICPA has promulgated a series of interpretive bulletins that provide guidance to auditors regarding the implementation of GAAS. Tr. 2690 (Potter). "AU" refers to GAAS and the AICPA's interpretive bulletins. Tr. 2690 (Potter); Tr. 2979 (Goldman).

14. GAAS is divided into three general categories: (1) general standards; (2) standards of field work; and (3) standards of reporting. GT Ex. 206 (AU 150.02); Tr. 2689–2690 (Potter).

15. GAAS has three general standards:

(1) The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor;

(2) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors; and

(3) Due professional care is to be exercised in the performance of the audit and the preparation of the report.

GT Ex. 206 (AU 150.02).

16. GAAS has three standards of field work:

(1) The work is to be adequately planned and assistants, if any, are to be properly supervised;

(2) A sufficient understanding of internal controls is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed; and

(3) Sufficient 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.

GT Ex. 206 (AU 150.02).

17. The standards of reporting require the audit report to state whether or not the financial statements are presented in accordance with Generally Accepted Accounting Principles ("GAAP"), and, if not, give the reasons. GT Ex. 206 (AU 150.02). When an overall opinion

cannot be expressed, the opinion should state the reason. GT Ex. 206 (AU 150.02); *see also* GT Ex. 214 (AU 316.26, .36); GT Ex. 215 (AU 317.18, .19, .20); GT Ex. 216 (AU 319.28).

2. <u>Obligation to Understanding Operational Characteristics</u>

18. Knowledge of an entity's operating characteristics assists the auditor in evaluating the reasonableness of management representations. GT Ex. 211 (AU 311.06).

19. Prior to conducting the audit, the auditor is required to "obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. The level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements." GT Ex. 211 (AU 311.06).

20. "The auditor's understanding of the client's arrangements and transactions with third parties is key to determining the information to be confirmed . . . ." GT Ex. 218 (AU 330.25); *see also* GT Ex. 211 (AU 311.08); Tr. 2709 (Potter).

21. Knowledge of key operating practices is gained, among other methods, by asking the personnel of the entity. GT Ex. 211 (AU 311.08).

3. <u>The "Due Professional Care" Standard</u>

22. The third general standard "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work." GT Ex. 210 (AU 230.02).

23. "The matter of due professional care concerns what the independent auditor does and how well he or she does it." GT Ex. 210 (AU 230.04).

24. The "due professional care" standard also mandates that auditors are assigned tasks and supervised in a manner consistent with their level of skill and experience so that the auditor is capable of evaluating the audit evidence. GT Ex. 210 (AU 230.06). "The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement." GT Ex. 212 (AU 312.17).

25. "Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence." GT Ex. 210 (AU 230.07) (emphasis original).

26. This standard dictates that an auditor "not be satisfied with less than persuasive evidence because of a belief that management is honest." GT Ex. 210 (AU 230.09); Tr. 2691–2693 (Potter).

27. "Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process." GT Ex. 210 (AU 230.08).

28. Grant Thornton's audit manual echoed the principles in AU 230. "We must maintain an attitude of appropriate skepticism in obtaining audit evidence. Accordingly, when applying procedures to the client's records, schedules and supporting data, we should be on guard to avoid accepting documents and explanations at face value." OCC Ex. 327 at GT 012350. This principle requires that an auditor employ a "show me" attitude. Tr. 3047 (Goldman).

4. **Reasonable Assurance**

29. GAAS is designed to assist the auditor in obtaining reasonable assurance that an entity's financial statements are free of material misstatements, whether caused by error or fraud. GT Ex. 205 (AU 110.02); Tr. 2976 (Goldman); Tr. 2684 (Potter).

30. "An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud. Accordingly, because of the above characteristics of fraud and the nature of audit evidence . . . the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements, including misstatements resulting from fraud, are detected." GT Ex. 214 (AU 316.10); see also GT Ex. 214 (AU 316.07).

31. "Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee." GT Ex. 210 (AU 230.13).

5. **Audit Risk**

32. "Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion." GT Ex. 212 (AU 312.12).

33. "Inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls." GT Ex. 212 (AU 312.27); GT Ex. 216 (AU 319.63).

34. “Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity’s internal controls.” GT Ex. 212 (AU 312.27(b)); GT Ex. 216 (AU 319.63).

35. “Audit risk” is the risk that the auditor “may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.” GT Ex. 212 (AU 312.02); *see also* GT Ex. 212 (AU 312.27).

36. “Inherent and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor’s procedures and can be changed at his or her discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less inherent and control risk that the auditor believes exists, the greater the detection risk that can be accepted. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk that can be accepted.” GT Ex. 212 (AU 312.28); *see also* GT Ex. 216 (AU 319.63).

37. “The auditor might make a separate or combined assessments of inherent risk and control risk. If he auditor considers inherent risk or control risk, separately or in combination, to be less than the maximum, he or she should have an appropriate basis for these assessments.” GT Ex. 212 (AU 312.31).

6. <u>Audit Risk Assessment</u>

38. Because the level of testing required by GAAS varies with the level of risk present, an assessment of the risk of material misstatements (whether caused by error or fraud) is required to be made during audit planning. GT Ex. 211 (AU 311.03); GT Ex. 214 (AU 316.01); GT Ex. 212 (AU 312.05, .08, .16).

39. The auditor is required to prepare an audit plan prior to commencing the audit taking into account the pre-audit assessment of risk and the auditor's understanding of the client's operating characteristics and arrangements with third-parties. GT Ex. 211 (AU 311).

40. The audit plan should be designed in light of the perceived risks, to detect misstatements that are large enough, individually or in the aggregate, to be quantitatively material to the financial statements. GT Ex. 212 (AU 312.20).

41. "Section 312 discusses the audit risk model. It describes the concept of assessing inherent and control risks, determining the acceptable level of detection risk, and designing an audit program to achieve an appropriate low level of audit risk. The auditor uses the audit risk assessment in determining the audit procedures to be applied, including whether they should include confirmation." GT Ex. 218 (AU 330.05).

42. "Assessing control risk is the process of evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions." GT Ex. 216 (AU 319.64.

43. The auditor's understanding of the internal controls may heighten concern about the possibility of material misstatements. GT Ex. 212 (AU 312.16); *see also* GT Ex. 211 (AU 311.09).

44. "After obtaining the understanding of internal control, the auditor may assess control risk at the maximum level for some or all assertions because he or she believes controls . . . are unlikely to be effective . . . . In circumstances where the auditor is performing only substantive tests in restricting detection risk to an acceptable level and where the information

used by the auditor to perform such substantive tests is produced by the entity's information system, the auditor should obtain evidence about the accuracy and completeness of the information." GT Ex. 216 (AU 319.65).

45. "Procedures directed toward evaluating the effectiveness of the design of a control

are concerned with whether that control is suitably designed to prevent or detect material misstatements in specific financial statement assertions." GT Ex. 216 (AU 319.75).

46. "The auditor also uses professional judgment in assessing control risk for an assertion related to the account balance or class of transactions. The auditor's assessment of control risk is based on the sufficiency of evidential matter obtained to support the effectiveness of internal control in preventing or detecting misstatements in financial statement assertions. If the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, . . . , he or she would assess control risk at the maximum." GT Ex. 212 (AU 312.30).

47. As part of the audit planning process, the auditor is required to "specifically assess

the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed." GT Ex. 214 (AU 316.12).

48. "The auditor should assess the risk of material misstatements due to fraud regardless of whether the auditor otherwise plans to assess inherent or control risk at the maximum (*see* AU 312.29 and 312.30)." GT Ex. 214 (AU 316.12 n.6).

49. Fraud risk factors "encompass both inherent and control risk attributes . . . ." GT Ex. 214 (AU 316.12 n.6).

50. GAAS recognizes three categories of fraud risk factors: (1) management characteristics; (2) industry conditions; and (3) operating characteristics and financial stability. GT Ex. 214 (AU 316.16).

51. Risk factors related to management characteristics include: (1) domination of management by a single person or small group, without effective oversight by the board of directors or audit committee; (2) inadequate monitoring of significant controls; (3) failure of management to correct known reportable conditions on a timely basis; (4) management's display of significant disregard for regulatory authorities; (5) management's continued employment of ineffective accounting, information technology, or internal auditing staff; and (6) high turnover of senior management. GT Ex. 214 (AU 316.17).

52. Risk factors related to industry conditions include: (1) new accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity; (2) a high degree of competition or market saturation, accompanied by declining margins; (3) declining industry with increasing business failures and significant declines in customer demand; and (4) rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence. GT Ex. 214 (AU 316.17).

53. Risk factors related to operating characteristics and financial stability include: (1) significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm; (2) significant, unusual, or highly complex transactions; (3) unusually rapid growth or profitability, especially when compared to other companies in the same industry; (4) especially high vulnerability to changes in interest rates;

(5) unusually high dependence on debt or marginal ability to meet debt repayment requirements; and (6) threat of imminent bankruptcy. GT Ex. 214 (AU 316.17).

54. "Professional skepticism" in light of fraud risk factors requires that an auditor exercise "increased sensitivity in the selection, nature and extent of documentation to be examined in support of material transactions," and an "increased recognition of the need to corroborate management explanations or representations concerning material matters, such as, examination of documents, or discussions with others within or outside the entity." GT Ex. 214 (AU 316.27).

55. Where fraud risk factors are present, "[t]he *nature* of audit procedures may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information." GT Ex. 214 (AU 316.28) (emphasis in original). This may require more evidence from independent sources as well as physical observation of certain assets. GT Ex. 214 (316.28).

56. The assessment of the risk of material misstatements due to fraud is a cumulative process, and risk factors may be identified during the audit process, including, but not limited to, (1) unsupported or unauthorized balances or transactions; (2) missing documents; (3) last minute adjustments that significantly change financial results; (4) unusual discrepancies between the entity's records and confirmation replies; and (5) unusual delays by the entity in providing requested information. GT Ex. 214 (AU 316.25).

7. Audit Procedures

57. "Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures." GT Ex. 212 (AU 312.01).

58. Higher risk requires the auditor to expand the extent of procedures applied, particularly in critically important areas, or it may cause the auditor to modify procedures in order to obtain persuasive evidence. GT Ex. 212 (AU 312.17).

59. "The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be applied to the account balance or class of transactions to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this section as substantive tests." GT Ex. 216 (AU 319.81).

60. "Whenever the auditor has concluded that there is a significant risk of material misstatements of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision." GT Ex. 212 (AU 312.17).

61. "The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk increases, the auditor designs substantive tests to obtain more or different evidence about a financial statement assertion." GT Ex. 218 (AU 330.07),

62. "An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence obtained may cause him or her to modify the nature, timing, and extent of other planned procedures. As a result of performing audit procedures or

from other sources during the audit, information may come to the auditor's attention that differs significantly from the information on which the audit plan was based. For example, the extent of misstatements detected may alter the judgment about the levels of inherent and control risks, and other information obtained about the financial statements may alter the preliminary judgment about materiality." GT Ex. 212 (AU 312.33).

a. "Tests of Details"

63. When the auditor has assessed the audit risk of material misstatements (whether caused by error or fraud) to be at the highest level, GAAS requires audit procedures commensurate with that risk in order to obtain sufficient evidential matter. GT Ex. 211 (AU 311.03(g)); GT Ex. 212 (AU 312.01, .16, .17); GT Ex. 214 (AU 316.12, .23, .27 and .28); GT Ex. 216 (AU 319).

64. "In selecting particular substantive tests to achieve the audit objectives he or she has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such tests. These considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter." OCC Ex. 782 (AU 326.05). As relevant to auditing the existence of Keystone's assertion of interest income from loans serviced by third-party servicers, a "test of details" refers to a substantive test that reviews primary financial documents such as, but not limited to, remittances and cash receipts, and traces

those items into bank records (Tr. 2718–2719 (Potter)), *i.e.*, a "test of details" "goes to the heart" of the interest income transactions with third-party servicers. Tr. 3018 (Goldman).

65. "Tests of details" provide stronger evidence than analytical tests because they are more reliable. Tr. 2719-2720 (Potter); Tr. 3085 (Goldman).

b. <u>Analytical Procedures</u>

66. An analytical procedure is a process were an auditor takes information present in the financial statements and compares it to other information in the financial statements to see if it is reasonable based upon "expected relationships." Tr. 2718 (Potter); Tr. 3018 (Goldman).

67. Under GAAS, an analytical test could be used as a substantive test in place of a "test of details" where a potential misstatement would not be apparent from an examination of the detailed evidence or where the detailed evidence is not readily available. OCC Ex. 781 (AU 329.12).

68. In connection with the use of analytical procedures as substantive evidence, GAAS requires the auditor to assess the reliability of such testing procedures under the following factors:

(1) Whether the data was obtained from independent sources outside the entity or from sources within the entity;

(2) Whether sources within the entity were independent of those who are responsible for the amount being audited;

(3) Whether the data was developed under a reliable system with adequate controls;

(4) Whether the data was subjected to audit testing in the current or prior year; and

(5) Whether the expectations were developed using data from a variety of sources.

OCC Ex. 781 (AU 329.16).

c. **Confirmation from Third Parties**

69. "Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. Section 326, *Evidential Matter*, states that, in general, it is presumed that 'When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.'" GT Ex. 218 (AU 330.06).

70. If information in an oral confirmation is "significant," the auditor is required to request that the parties involved "submit a written confirmation of the specific information directly to the auditor." GT Ex. 218 (AU 330.29); Tr. 2714 (Potter).

71. "Unusual or complex transactions may be associated with high levels of inherent and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity." GT Ex. 218 (AU 330.08).

72. "The auditor should assess whether the evidence provided by confirmations

reduces audit risk for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessment." GT Ex. 218 (AU 330.09).

73. "The auditor should exercise an appropriate level of professional skepticism throughout the confirmation process (*see* section 230, *Due Professional Care in the Performance of Work*). Professional skepticism is important in designing the confirmation request, performing the confirmation procedures, and evaluating the results of the confirmation procedures." GT Ex. 218 (AU 330.15).

8. Grant Thornton's Audit Manual

74. AU 161 requires that an auditing firm develop its own procedures to assist its auditors in the implementation of GAAS. Tr. 2690 (Potter).

75. "The GTI Audit Approach refers to the term 'Environmental' as meaning the combination of inherent risk and the control environment." OCC Ex. 327 at GT 012405.

76. "In the GTI Audit Approach, '*Environmental Risk Assessment*' is a term used to characterize general and specific factors that might affect the nature, timing and extent of our substantive audit procedures. We evaluate inherent and control environment together since some of these factors include elements relating to both. Environmental risk is the key element in determining the nature, timing and extent of our audit." OCC Ex. 327 at GT 012404.

77. As explained in Grant Thornton's auditing manual, "inherent risk is the susceptibility of an assertion to material misstatement, assuming there are no related internal controls. This risk is greater for some assertions and related accounts than for others. Assessing inherent risk, therefore, requires the evaluation of numerous subjective factors, including factors

peculiar to the related assertion and factors pervasive to the financial statements and the client's business environment taken as a whole." OCC Ex. 327 at GT 012405.

78. "The control environment represents the collective effect of various factors on establishing, enhancing or mitigating the effectiveness of specific policies and procedures. Such factors include:

- integrity and ethical values
- commitment to competence
- board of directors or audit committee participation
- management's philosophy and operating style
- organizational structure
- assignment of authority and responsibility
- human resource policies and practices.

OCC Ex. 327 at GT 012405.

79. "The control environment reflects the overall attitude, awareness and actions of the board of directors, management, owners and others concerning the importance of control and its emphasis in the entity. An effective control environment interacts with control systems to achieve specific internal control objectives. It may reduce the impact that the absence of certain control systems might otherwise have on the risk of material misstatement in the financial statements. On the other hand, the effectiveness of control systems may be impaired by an ineffective control environment." OCC Ex. 327 at 0123405.

80. Grant Thornton's audit manual used the term "maximum" in its audit matrix to

identify the highest level of risk. "Based on the general and specific factors, the audit team assesses environmental risk as limited, moderate or maximum environmental risk." OCC Ex. 327 at GT 012346.

81. Because there were no material time or economic restraints placed upon Grant Thornton in planning or conducting the 1998 audit of Keystone's financial statements (Tr. 2715 (Potter); *see also* Tr. 3122–3123 (Goldman)), GAAS required that auditors obtain the best evidence available. Tr. 2722–2724 (Potter); Tr. 3122 (Goldman); *see* OCC Ex. 782 (AU 326.23).

C. The Securitization Program

1. Keystone's Original Program (1992-1997)

82. Prior to 1992, Keystone was a small bank with about $100 million in assets that lent mostly in its local area and concentrated on single-family-home lending. Tr. 1208–1209 (Blair); GT Ex. 10 at 1.

83. In 1992, however, Keystone radically changed its business plan and began growing rapidly. Tr. 565 (Gerardy); Tr. 1209–1210 (Blair); GT Ex. 10 at 1. By 1997, Keystone was reporting assets of approximately $1 billion. GT Ex. 10 at 2. Keystone generated this growth through the securitization of high-loan-to-value ("HLTV") second and third mortgage loans. Tr. 565 (Gerardy); Tr. 1209–1210 (Blair); GT Ex. 10 at 1-2.

84. Through its operating subsidiary Keystone Mortgage Corporation ("KMC"), Keystone would acquire these loans from large originators located throughout the country using brokered deposits and Federal Home Loan Bank of Pittsburgh ("FHLB-Pittsburgh") advances to fund these acquisitions. Tr. 1209–1210 (Blair); Tr. 92–93 (Schneck); GT Ex. 10 at 1, 2.

85. Keystone would "re-underwrite" these loans to assure itself that the loans met securitization standards. Underwriting is the process of determining that the borrower meets the applicable credit criteria and standards, including the borrower's credit rating, income level, and ability to make payments, and that a security interest has been obtained in appropriate collateral. Re-underwriting meant that Keystone would double-check the underwriting that was done by the originator to assure that the criteria established for the securitization program were met. Tr. 1545, 1549–1550 (Wilson, J.).

86. Prior to the securitization, Keystone relied upon asset servicers to collect the principal, interest and penalties on the loans and to send Keystone monthly interest income checks. Tr. 92, 96–97 (Schneck); GT Ex. 10 at 1.

87. Once Keystone had purchased a sufficient number of loans, Keystone would establish a trustee to whom the loans would be sold. The trustee would issue securities and pay Keystone for the loans from the proceeds received in connection with the sale of the securities. Each security represented a proportional ownership interest in loans in the pool. Tr. 1209–1210 (Schneck); GT Ex. 10 at 1-2.

88. Keystone would retain the residual interest in the securitizations as an asset. GT Ex. 10 at 1. "Residual assets represent the cash flows, if any, that will be received in excess of the contractual servicing fee and other costs associated with securitized assets." GT Ex. 10 at 1 n.3.[1]

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[1] Typically, the seller of the loans to the security trustee receives an interest in the assets (loans) sold, which represents the right to cash flows and other assets not required to meet financial obligations to the owners of the securities and to pay credit losses, servicing fees and other expenses of the trust. *See* OCC Bulletin 99-46 (Dec. 14, 1999).

2. **The Keystone/United Program (1998-99)**

89. Keystone's securitization program changed profoundly in February 1998, when Keystone finalized an arrangement with United National Bank ("United"), Wheeling, West Virginia, in which Keystone began purchasing loans as agent for United. United provided all of the funding to purchase loans destined for a Keystone securitization and the loans were owned by United. Tr. 1535, 1545–1546, 1553–1554, 1572 (Wilson); OCC Ex. 243; OCC Ex. 244; OCC Ex. 277; OCC Ex. 283; OCC Ex. 645.

90. The loan originators would advise Keystone of loans available for purchase. Tr. 1572 (Wilson, J.). Keystone would then "re-underwrite" the loans and send a daily list of qualified loans and their purchase price to United. Tr. 1571–1572 (Wilson); OCC Ex. 277. In turn, United would wire to Keystone funds equal to the purchase price. OCC Ex. 277.

91. United provided funding for this arrangement instead of just lending the money to Keystone because of United's legal lending limit of approximately $40 million. Tr. 1547 (Wilson, J.). United anticipated that it would own anywhere from $200 million to $250 million in loans under the arrangement at any one time in a build-up to a securitization. Tr. 1547 (Wilson, J.).

92. Keystone, acting as United's agent, would wire the purchase funds to the loan underwriters and United would become the owner of the loans. Tr. 1546, 1552, 1572 (Wilson); OCC Ex. 245; OCC Ex. 277; OCC Ex. 283 ; OCC Ex. 645.

93. The loan originators would transfer to Keystone all loan files and legal documents, and Keystone would then send the original note and mortgage to United. Tr. 1572–1573 (Wilson, J.); OCC Ex. 277.

94. The credit files for the loans would remain with Keystone. Tr. 1557, 1573 (Wilson, J.); OCC Ex. 277. At the same time, Keystone would send information to the primary third-party servicer, Compu-Link Loan Service, Inc. ("Compu-Link"), on each loan that United was purchasing. OCC Ex. 277.

95. Compu-Link would confirm to Keystone the loans that were being purchased by United, as well as confirm to United that these loans were being purchased by United and "boarded on their system." Tr. 1573 (Wilson, J.); OCC Ex. 277.

96. Because United – not Keystone – owned the loans, Compu-Link sent United monthly remittances in connection with the interest income on the loans they were servicing for United. United would own loans purchased under this arrangement for "anywhere from 90 to 150 days" at which time they would be transferred to the securitization trustee in connection with a Keystone securitization. Tr. 1546 (Wilson, J.).

97. Contemporaneously with a securitization, Keystone would exercise a 180-day option to purchase the loans from United. Tr. 1547, 1549, 1553 (Wilson, J.); OCC Ex. 242. Keystone would pay United for the loans out of proceeds that the securitization trustee received from the purchasers of the securities to be sold in connection with the securitization. Accordingly, the loans would be transferred from United to Keystone and simultaneously to the securitization trustee with the closing of the securitization. Tr. 1554 (Wilson, J.); OCC Ex. 277; OCC Ex. 242.

98. Prior to 1998, Keystone retained 100 percent of the residual interest in each securitization. GT Ex. 10 at 1.

99. Starting in 1998, in return for United granting Keystone the option to purchase the loans from United, Keystone promised to provide United with a twenty-percent interest in the residual interest of securitizations resulting from the Keystone/United arrangement. Tr. 1557 (Wilson, J.); OCC Ex. 242.

100. Although United originally expected that in 1998 it would be holding approximately $200 to $250 million in loans at any one time under the Keystone/United relationship, United at one point was holding approximately $500 million in loans under the arrangement. Tr. 1548 (Wilson, J.).

101. On behalf of United, in 1998 Keystone acquired, on average, approximately $3 to $4 million in loans each business day. Tr. 1578 (Wilson, J.); *see also* Tr. 1547, 1576 (Wilson, J.).

102. During 1998, United bought about 10,000 loans valued at approximately $960 million. Tr. 1576 (Wilson, J.).

103. The first Keystone/United securitization (P1, $168 million) closed in May 1998, and the second securitization (P2, $340 million) closed in September 1998. Tr. 1574–1575 (Wilson, J.).

104. When the P1 and P2 securitizations occurred, United's total volume of loans available for sale dropped by $168 million in May 1998 and $340 million in September 1998, respectively. Tr. 1578:21–1579:9 (Wilson, J.).

105. Between mid-September and mid-December 1998, Keystone began preparing for a third securitization ("P3") and, once again as agent for United, bought additional loans which continued to be serviced by Compu-Link. Tr. 1577, 1581 (Wilson, J.).

106. In late 1998, the servicing of $236 million in United loans and $6.3 million in Keystone loans was transferred from Compu-Link to Advanta Mortgage Corporation USA ("Advanta"), because Compu-Link, at that time, lacked the necessary Wall Street rating as a loan processor. Tr. 1582, 1583 (Wilson, J.).

107. Advanta held the United loans in a file called Investor No. 406. OCC Ex. 744b (Ramirez Dep. at 141–143). Advanta held loans owned by Keystone in a file called Investor No. 405. OCC Ex. 744b (Ramirez Dep. at 141–143).

108. In mid-December 1998, Keystone abruptly informed United that P3 would not occur. Tr. 1584 (Wilson, J.). United was disappointed by the cancellation of P3 because it had planned to reduce its holding of loans acquired under the Keystone/United arrangement from $450 million to about half of that in connection with that securitization. Tr. 1584 (Wilson, J.).

109. In response to Keystone's cancellation of P3, United immediately stopped buying loans through its arrangement with Keystone, even though all of the underlying agreements stayed in place. Tr. 1593 (Wilson, J.); OCC Ex. 474.

110. Despite the cancellation of P3, Advanta continued to service the $236 million in United loans, under "Investor No. 406." Tr. 1595 (Wilson, J.).

111. United informed Keystone that United was considering "proceeding with a securitization" of its own. OCC Ex. 474. Because United had no experience in securitizing loans, United needed Keystone's assistance. Tr. 1603 (Wilson, J.).

112. Keystone agreed to assist United in executing United's own securitizations and, in effect, Keystone "did about the same thing that they would do if they were doing their own securitization. They worked with the investment banker that [United] selected. They provided

the information that the due diligence team needed to review in connection" with re-underwriting the loans. Tr. 1603–1604 (Wilson, J.).

113. With Keystone's assistance, United closed its first securitization, called "1999 P1 securitization," on March 26, 1999, in the amount of $205 million. Tr. 1604–1605 (Wilson, J.). These loans came from United loans being serviced by Advanta under "Investor No. 406." Tr. 1605 (Wilson, J.).

114. A second United securitization, called 1999 P2, closed in mid-April 1999. Tr. 1605 (Wilson, J.).

D. Grant Thornton Did Not Understand the 1998 Securitization Program

115. Grant Thornton's auditing manual addressed the GAAS instruction that "[t]he auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his or her judgment, may have a significant effect on the financial statements." GT Ex. 211.03 at 241 (AU 311.06).

116. Grant Thornton's audit manual emphasized that in carrying out GAAS it was "key" and "critical" that an auditor understand a client's important operational transactions:

> Knowledge of the client's business is critical to our overall client relationship and is a key element of our planning procedures. Knowledge of the client's business . . . is key to the determination of critical transaction cycles and assertions.

OCC Ex. 327 at GT 012400. Grant Thornton's audit manual also stated that "[a]udit planning

. . . should first be directed toward gathering information about features of the client's business and operations which will enable us," among other things, "to plan and carry out the audit work more effectively and efficiently by . . . assessing the risk of material misstatements in the financial statements." OCC Ex. 327 at 012400.

117. As part of the planning process, Mr. Quay, Grant Thornton's lead auditor, asked Keystone management for all documents material to its operations but did not receive any documents related to the Keystone/United relationship (Tr. 1999–2000 (Quay)). Neither Mr. Quay nor anybody else associated with Grant Thornton asked Keystone specifically for documents related to its 1998 securitizations, including Keystone's relationship to United, or asked Keystone management to explain Keystone's relationship with United.

118. The Keystone/United relationship was Keystone's most significant relationship. Tr. 2703 (Potter). The relationship required significant transfers of money, numerous wire transfers into the bank and numerous entries into Keystone's general ledger. Tr. 2703 (Potter)

119. Grant Thornton's understanding of Keystone's 1998 securitization program was not in accordance with GAAS. Tr. 2704, 2709 (Potter).

120. Grant Thornton did not know that "Keystone was buying substantial loans for United National Bank at the time of the audit" or that loans used in the 1998 securitizations were owned and financed by United. Tr. 1996 (Quay).

121. Ms. Buenger's only auditing experience had been in connection with community banking, which primarily involved loans held by a financial institution for its own portfolio, and she had little experience with securitizations. Tr. 2335, 2359, 2412–2413 (Buenger).

122. Grant Thornton mistakenly believed that the loans that went into Keystone's two 1998 securitizations were funded and owned by Keystone prior to the loans being transferred to the trustee at closing. OCC Ex. 85; *see also* OCC Ex. 101 at GT/F at 06054. Grant Thornton believed that Keystone was using brokered deposits to fund its securitizations in 1998 (Tr. 2414 (Buenger), even though Keystone's use of brokered deposits as a funding source had been restricted by the OCC. OCC Ex. 35 at 1; OCC Ex. 268 at 000284; *see also* OCC Ex. 292 at 0003641; Tr. 493–494 (Schneck); Tr. 639–640 (Gerardy);

123. Mr. Quay did not know the details of the Keystone/United relationship (Tr. 1996–1997 (Quay); OCC Ex. 101) even though he understood that the relationship was "a significant material relationship." Tr. 2301–2302 (Quay).

124. Ms. Buenger, the Grant Thornton project manager who worked directly for Mr. Quay, acknowledged that someone at Grant Thornton should have understood the Keystone/United relationship. Tr. 2517, 2532–2534 (Buenger).

125. Ms. Buenger believed it was not important for her to understand Keystone's securitizations because "that was Mr. Quay's responsibility." Tr. 2623 (Buenger). She did not know where the loans used in the P-2 1998 (September) securitization came from. Tr. 2601–2602 (Buenger).

126. As part of the agreed upon accounting procedures required under the Formal Agreement, Mr. Quay reviewed the documentation related to the two 1998 securitizations in order to determine the extent to which the original residual and the gain on sale that Keystone recorded appeared reasonable. Tr. 1996 (Quay); OCC Ex. 76 at GT/F 00707. Mr. Quay was aware that United was providing loans for the 1998 securitizations, but he was unaware that

those loans came from loans Keystone was acquiring on behalf of United under the Keystone/United arrangement. Tr. 1996 (Quay).

E. OCC Regulatory Actions Prior to Grant Thornton's Engagement

127. Almost from the very beginning of the securitization program in 1992, the OCC had significant concerns about the reliability of Keystone's books and records, including Keystone's chronically inaccurate Reports of Condition and Income ("Call Reports"), and its lack of internal controls. OCC Ex. 1 at 1–3; OCC Ex. 3 at 1-5.

128. The OCC's 1997 report of examination ("ROE") was particularly critical of the bank, and indicated that supervision of Keystone had been transferred from the District Office to OCC's Special Supervision Division in Washington, D.C. OCC Ex. 5; GT Ex. 185 at 000220.

129. The OCC's 1997 ROE gave Keystone an unsatisfactory composite CAMELS rating of "3", and an unsatisfactory management rating of "4." OCC Ex. 5; GT Ex. 185 at 000222; Tr. 74 (Schneck) (explaining CAMELS system).

130. In February 1998, the OCC informed Keystone that all Call Reports for 1997, including the two quarters following the OCC's 1997 ROE, were inaccurate and required amendment. OCC Ex. 31 at 011228-0416, 011228-0418. The OCC also informed Keystone that the bank had not addressed many of the accounting and internal controls problems noted in the OCC's 1997 ROE. OCC Ex. 31.

131. On May 8, 1998, the OCC informed Keystone that it was considering the imposition of civil money penalties ("CMPs") in connection with Keystone's inaccurate 1997 Call Reports (OCC Ex. 33), and in December 1998, just as the Grant Thornton audit was getting underway, Keystone's directors consented to pay CMPs in connection with the inaccurate 1997

Call Reports. OCC Ex. 72. Ms. Terry Church, senior vice president of Keystone, paid a CMP of $13,000. OCC Ex. 72 at 011234-0678. Each of the other directors paid a CMP of $2,000. OCC Ex. 72.

132. On May 28, 1998, Keystone and the OCC entered into a Formal Agreement. OCC Ex. 353.

133. The Formal Agreement required, among other things, that Keystone retain a nationally recognized accounting firm to audit the bank and correct the accounting and internal control deficiencies noted in the OCC's 1997 ROE. Specifically, the Formal Agreement required that a national accounting firm be retained, among other things, to:

(1) "perform an audit of the Bank's mortgage banking operations and determine the appropriateness of the Bank's accounting for purchased loans and all securitizations" (OCC Ex. 353 at GT/F 07226);

(2) reconcile Keystone's records and loan servicer records (OCC Ex. 353 at 07227); and

(3) assess the appropriateness of all carrying values of entries on the balance sheet and income statement (OCC Ex. 353 at GT/F 07227).

134. In addition, the Formal Agreement required Keystone to:

(1) address the bank's lack of internal controls by hiring a chief financial officer (OCC Ex. 353 at GT/F 07228);

(2) "adopt and implement procedures to ensure accurate monthly reconciliations of all general ledger accounts by parties independent of the

input and output functions, and the accuracy of the purchased loan's [sic] data base" (OCC Ex. 353 at GT/F 07228);

(3) "adopt and cause the Bank to implement written policies and procedures, in accordance with the Instructions for Preparation of Reports of Condition and Income, to ensure that all official and regulatory reports filed by the bank accurately reflect the Bank's condition as of the date that such reports are submitted (OCC Ex. 353 at GT/F 07229).

(4) "develop and implement a written program to improve the Bank's loan administration," in accord with ten specific criteria (OCC Ex. 353 at GT/F 07229-07231);

(5) establish an independent loan review system to assess quarterly the loan portfolio to assure the timely identification of problem loans or other trends within the portfolio, in accord with ten specific criteria (OCC Ex. 353 at 07231-07232);

(6) adopt and implement an independent, internal audit program with reporting responsibility to the board of directors, according to specified criteria (OCC Ex. 353 at GT/F 07233-07234);

(7) develop policies and procedures to ensure compliance with all applicable laws and regulations (OCC Ex. 353 at GT/F 07235); and

(8) develop policies and procedures to monitor the bank information systems (*i.e.*, computer systems) (OCC Ex. 353 at GT/F 07237).

135. One month after the Formal Agreement was effective, the OCC, in June 1998, informed Keystone that it was "undercapitalized" and, accordingly, Keystone was prohibited from accepting, renewing, or rolling over brokered deposits. OCC Ex. 35 at 1; OCC Ex. 268 at 000284; *see also* OCC Ex. 292 at 0003641. In addition, the FHLB-Pittsburgh placed the bank's line of credit in "full collateral status," *i.e.*, began requiring physical possession of loans used by Keystone as collateral for FHLB-Pittsburgh borrowings. OCC Ex. 35 at 1. Being "undercapitalized" also meant that Keystone was restricted in terms of asset growth and prohibited from paying dividends. OCC Ex. 35 at 1.

F. Grant Thornton Was Aware of Prior and Current OCC Regulatory Actions

136. Grant Thornton reviewed the OCC's 1997 ROE and the Formal Agreement as early as July 1998. Tr. 2270 (Quay); Tr. 2325–2326 (Buenger); OCC Ex. 297; *see also* OCC Ex. 298 at GT/F 07172 (Grant Thornton possessed OCC's 1998 ROE in January 1999).

137. In late July 1998, just as the OCC examiners were completing their 1998 examination of Keystone (OCC Ex. 268 at 000283), the bank chose Grant Thornton as its external auditor. OCC Ex. 286; OCC Ex. 287.

138. Even though the audit engagement letter was not finalized until September 1998 (OCC Ex. 288) and the audit did not begin until late December 1998, Grant Thornton began, in August 1998, tasks required by the Formal Agreement, including reviewing accounts, valuing Keystone's residual assets, and interacting with Keystone management and OCC examiners at the bank. Tr. 631–635, 636–637 (Gerardy); Tr. 2314, 2333–2335 (Buenger); OCC Ex. 52; OCC Ex. 291.

139. In early December 1998, just weeks before Grant Thornton began its audit of

Keystone's 1998 financial statements, Grant Thornton representatives attended a meeting between the OCC examiners and Keystone management the purpose of which was to discuss the findings and conclusions of the OCC's 1998 ROE. OCC Ex. 292. The OCC distributed to Keystone board directors, Keystone's management, and Grant Thornton, a preliminary draft of the OCC's 1998 ROE. Tr. 2200 (Quay); OCC Ex. 292 at 003636. The OCC examiners stated at this meeting that Keystone had misstated its assets by about $90 million (almost ten percent of the bank's assets) in connection with three separate misstatements:

(1) Mr. Michael Graham, a KMC officer, made an unexplained $31 million "input error" into a model used to evaluate Keystone's residual interests in its securitizations;

(2) Keystone had recorded ownership of $44 million in trust accounts even though they were not Keystone assets; and

(3) Keystone claimed ownership of $16 million in residual interests in securitizations even though Keystone had pledged those interests to other parties.

OCC Ex. 292 at 003638, 003642–003643.

140. At the meeting between OCC examiners and Keystone management (and in Grant Thornton's presence), OCC examiners discussed a draft of the OCC's 1998 ROE that accused Ms. Church of "manipulating" the bank's risk-based capital calculation in order to make it appear that the bank qualified for "well-capitalized" status. OCC Ex. 292 at 003638, 003642; Tr. 2201-2202 (Quay).

141. Grant Thornton noted in its audit planning memorandum that the OCC examiners had questioned the integrity of Ms. Church in connection with the bank's risk-based capital calculation related to its September 1998 Call Report:

> During the review of the ROE referenced above, a question of Terry Church's integrity was raised. The OCC accused the client of "manipulating" the loans that qualified to be treated at a lower risk weighting in order to receive an [sic] "well-capitalized" PCA category.

OCC Ex. 76 at GT/F 00710; Tr. 2201, 2211–2212 (Quay); Tr. 2344–2346 (Buenger).

142. The specifics of the OCC's suspected manipulation of Keystone's Call Reports by Ms. Church were as follows:

(1) The misclassification of Keystone's assets for risk-based capital purposes by Keystone's controlling officer, Ms. Church, inappropriately put Keystone into the "well capitalized" category under the prompt corrective action ("PCA") standards of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") (OCC Ex. 268 at 000291, 000294, 000304);

(2) Maintaining "well-capitalized" status was critical to Keystone's operations because without that status Keystone could not solicit out-of-the-area brokered deposits, a key source of funding for its securitizations because there were not enough local deposits available to fund Keystone's operations. Tr. 493–494 (Schneck); Tr. 639–640 (Gerardy); OCC Ex. 35; OCC Ex. 64 at 2; OCC Ex. 491;

(3) Keystone's September 1998 Call Report claimed that for purposes of calculating Keystone's risk-based capital ratio, Keystone was entitled to

favorable treatment of $760 million in securitized loans. Ms. Church claimed that these loans were first-lien residential mortgages with a ninety percent or greater loan-to-value ratio, which had the effect of reducing Keystone's minimum capital requirements by allowing assets to qualify for a fifty percent risk weighting. Tr. 495–497 (Schneck); Tr. 638–640 (Gerardy); Tr. 1794–1802 (Carney);

(4) OCC examiners determined that Keystone's method of identifying loans qualifying for fifty percent risk weighting for risk-based capital purposes was "severely flawed" and led to an erroneous risk-based capital ratio. OCC Ex. 268 at 000291.

143. At the OCC's insistence, the loans were reviewed for risk-based capital purposes and it was determined that only $21 million of the $760 million qualified for favorable risk-based capital treatment. OCC Ex. 64 at 2; OCC Ex. 268 at 000294; OCC Ex. 290 at 000041; Tr. 652 (Gerardy); Tr. 1993 (Quay). The adjustment to the bank's risk-based capital calculation, alone, moved Keystone from "well-capitalized" to "adequately capitalized," with further downward adjustments expected to follow for other reasons. OCC Ex. 64 at 2.

144. The OCC's 1998 ROE observed that Keystone was dominated by one person, Ms. Church, who functions as the bank's president. OCC Ex. 268 at 000292.

145. The OCC's 1998 ROE also noted that Ms. Billie Cherry, Keystone's president, was little more than a public relations figure who did not understand the operations of the bank. OCC Ex. 268 at 000292.

146. Neither the board of directors nor others in management wielded the power that Ms. Church effectively exercised over the operations of Keystone. Tr. 615–616 (Gerardy); Tr. 1834–1835, 1842–1843 (Carney); Tr. 2319–2320 (Buenger); Tr. 3131–3132 (Goldman).

147. The OCC's 1998 ROE stated with respect to inaccurate Call Reports and Keystone's accounting records:

> The board and management have failed to establish accounting standards and internal controls to ensure accurate record keeping. The September 30, 1998 Call Report reported substantiated risk based capital numbers that allowed the bank to erroneously report a "well capitalized" position. The bank has not filed an accurate call report in the last seven filings [quarters]. It is extremely difficult to trace transactions within the bank's accounting system. We noted numerous journal entries affecting the balance sheet and income statement that were incorrect and materially misstated the financial condition of the bank. Because of the errors, the bank will need to restate their 1997 financial statements and the June and September 1998 call reports. In addition, the bank's representation letter lacks work paper support to ensure that internal controls are in accordance with COSO standards."

OCC Ex. 268 at 000304.

148. In the opinion of the OCC's 1998 ROE, Keystone's safety and soundness was deteriorating. OCC Ex. 268 at 000283. The OCC's major criticisms in the 1998 ROE related to:

(1) insufficient capital levels based upon the large concentration of risky assets on the balance sheet;

(2) inadequate liquidity levels given the capital category and related deposit restrictions;

(3) flawed residual valuation methodology and unreliable estimates of fair value;

(4) deficient accounting and record-keeping;

(5) continued unsatisfactory management and board supervision; and

(6) the need for the board of directors to strengthen its efforts to comply with the terms of the Formal Agreement.

OCC Ex. 268 at 000283–000286.

149. The OCC's 1998 ROE noted that:

(1) the bank's earnings were exposed to high levels of credit, liquidity, market sensitivity, strategic and reputation risk, and that any one of these risks posed the potential to severely and quickly diminish the level of earnings, and that "a combination of these risks could be devastating to bank income." (OCC Ex. 268 at 00306);

(2) the bank's undercapitalized PCA status as of September 1998 placed restrictions on the ability of the bank to use brokered deposits or grow assets, which would likely force the bank to sell assets for liquidity needs; and

(3) Keystone's funding sources were no longer available to meet the bank's needs; brokered deposits were unavailable because of regulatory restrictions, and warehouse lines were unavailable due to the bank's condition and marketplace reputation. OCC Ex. 268 at 000308.

150. The OCC's 1998 ROE downgraded the bank's composite CAMELS rating from "3" to "4," and downgraded the management rating for the bank from "4" to "5." OCC Ex. 268 at 00283.

151. In February 1999, the OCC informed Ms. Church and others at Keystone that the OCC was contemplating the assessment of additional CMPs against them in connection with the findings in the OCC's 1998 ROE. OCC Ex. 105. At the time Grant Thornton was conducting the audit, it knew that the OCC was in the process of assessing CMPs. Tr. 2346, 2427 (Buenger); Tr. 1951 (Quay).[2]

G. Although Grant Thornton Assessed the Audit Risk at the Maximum, It Did Not Conduct a Maximum-Risk Audit

1. As Required by GAAS, Grant Thornton's Audit Manual Required Greater "Professional Skepticism" Commensurate With the Audit Risk

152. In accordance with GAAS (GT Ex. 211 (AU 311)), Grant Thornton's audit manual required that a written audit plan be prepared after an environmental risk assessment and a control risk assessment were completed. OCC Ex. 327 at GT 012345; *see also* OCC Ex. 327 at GT 012404.

153. For the environmental-risk assessment, the Grant Thornton manual listed three categories: (1) "maximum risk (resulting in no reduction in substantive procedures)"; (2) "moderate risk (resulting in some reduction in substantive procedures)"; and (3) "limited risk (resulting in maximum reduction in substantive procedures.")). OCC Ex. 327 at GT 012405.

154. For the control risk assessment, Grant Thornton used the following four categories: (1) maximum risk; (2) slightly below maximum risk; (3) moderate risk; and (4) limited risk. OCC Ex. 297 at GT/F 00530; OCC Ex. 327 at GT 012346.

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[2] In July 1999, the OCC assessed a $100,000 CMP against Ms. Church, and CMPs in the amount of $25,000 each against other directors and officers. OCC Ex. 520. These CMPs were stayed when the OCC closed the bank and appointed the Federal Deposit Insurance Corporation ("FDIC") as receiver on September 1, 1999. Tr. 657–658 (Gerardy); Tr. 301–304 (Schneck).

155. Under the terms of the Grant Thornton audit manual, the assessments of environmental and control risk required certain audit-procedure outcomes:

> [T]he higher our environmental and control risk assessments, the greater the assurance we need to gain from analytical procedures and tests of details. Conversely, as our environmental and control risk assessments decrease, the less assurance we need from substantive procedures. In such circumstances, we would be justified in reducing tests of details and gathering evidence from less time consuming work, such as analytical procedures.

OCC Ex. 327 at GT 012342.

156. The Grant Thornton audit manual used a matrix to adjust audit procedures to the environmental and control risk assessments.

> The strategy we will follow for a particular critical assertion [*e.g.*, asset ownership and interest income] will depend upon the results of evidence gathered during the planning stage of the audit relative to environmental assessment; understanding and testing of the accounting system and related internal controls, and the application of preliminary analytical procedures.

OCC Ex. 327 at 012342.

157. Based upon the rating given under the environmental-risk assessment and the control-risk assessment, the Grant Thornton audit manual provided that one of three audit strategies would be employed: (1) the "A"nalytical approach; (2) the "B"asic approach; and (3) the "C"omprehensive approach. OCC Ex. 327 at GT 012344.

158. The Grant Thornton audit manual described in text the type of procedures to be employed depending upon which of the three audit strategies was identified as applicable under the circumstances. Where the assessment of environmental risk and control risk were rated low, the Grant Thornton manual permitted the use of the "Analytical" audit:

> The analytical approach minimizes tests of details on the assumption that environmental factors, the accounting system and control procedures are sufficiently strong to allow us to accept maximum detection risk. Therefore, this strategy concentrates on scanning, inquiry, and analysis . . . of account balances or transactions so that tests of details, if any, are performed only on those items that warrant a detailed examination. The analytical approach places significant emphasis on understanding and testing of the client's internal control systems.

OCC Ex. 327 at GT 012344.

159. In situations where the two assessments indicated that a somewhat greater audit risk was present, the matrix permitted the use of a "Basic" audit:

> The basic approach generally requires analytical procedures to be augmented with tests of details because we will have minimized the tests of controls that could otherwise result in a lower assessment of control risk. This strategy generally emphasizes analytical procedures on income statement accounts and tests of details, on a reduced scope basis, for balance sheet accounts.

OCC Ex. 327 at GT 012344.

160. In situations where Grant Thornton determined that audit risk was at the "maximum," the Grant Thornton audit manual required that a "Comprehensive" audit be conducted:

> The comprehensive approach relies primarily upon tests of details because . . . environmental factors, accounting system or control procedures are sufficiently weak to cause the possibility of a material misstatement occurring in the related financial statement account to be high. . . Therefore, this strategy generally concentrates on tests of details for both balance sheet and income statement accounts. If analytical procedures are performed for the purpose of providing substantive evidence, they are generally proof-in-total or other very strong analytical procedures.

OCC Ex. 327 at GT 012344; *see* Tr. 2409 (Buenger) (Ms. Buenger did not understand meaning of "proof-in-total").

161. The Grant Thornton manual graphically illustrated the types of tests to be "emphasized" for each type of audit:

ABC Audit Strategy Matrix

Environmental Risk Assessment	Control Risk Assessment			
	Limited	Moderate	SBM	Maximum
Maximum	C	C	C	C
Moderate	A	B	B	C
Limited	A	A	B	C

OCC Ex. 327 at GT 12346.

162. The manual contained a graph describing the types of audit procedures to be emphasized depending upon the type of audit to be conducted:

Type of Procedures Emphasized: Test of Details or Analytical

ABC Approach	Balance Sheet	Income Statement
A	Analytical	Analytical
B	Test of Details	Analytical
C	Test of Details	Test of Details

OCC Ex. 327 at GT 102345.

2. Grant Thornton Was Aware of Multiple "Red Flags" At the Time the Audit Was Planned

163. When Grant Thornton planned its audit of Keystone, there were numerous "red flags" indicating that the financial statements with respect to asset ownership and associated interest income could be misstated. Tr. 2696-2697, 2804 (Potter).

164. Grant Thornton's auditing partner, Mr. Quay, characterized the banks records as "atrocious." Tr. 1081–1082 (Wilson, C.); Tr. 1215 – 1216 (Blair); Tr. 1818–1819 (Carney); *see also* OCC Ex. 268 at 000290, 000304.

165. Grant Thornton noted in its audit planning memorandum that the Formal Agreement required Keystone to do the following: (1) hire a chief financial officer; (2) develop policies and procedures to ensure accurate completion of call reports and maintain the financial records to ensure an audit trail; (3) develop and implement internal loan review functions; (4) develop and implement an internal audit function with reporting responsibility to the bank's board of directors; and (5) develop policies and procedures to ensure compliance with all applicable laws and regulations. OCC Ex. 76 at GT/F 00702, GT/F 00702.1. Grant Thornton observed that some of these areas potentially affected the accounting and reporting functions of the bank. OCC Ex. 76 at GT/F 00702.

166. From the very beginning of its relationship with Keystone, Grant Thornton knew that it could not rely upon Keystone's internal controls and that the bank's financial records were unreliable:

(1) Keystone's internal controls were weak and Grant Thornton could not rely upon the bank's "internal control structure." Tr. 2331–2333 (Buenger), Tr. 3051, 3131 (Goldman) Tr. 2729-2730 (Potter);

(2) Keystone did not have an effective internal control function. Tr. 2331-2333 (Buenger);

(3) Keystone's books and records were unreliable. Tr. 3050–3051 (Goldman); and

(4) Grant Thornton did not obtain an appropriate understanding of Keystone's internal controls and never tested Keystone's internal controls for reliability. Tr.3019, 3051 (Goldman), Tr. 2701 (Potter).

167. Grant Thornton was aware at the time it planned its audit that "multiple risk factors beyond the normal risks normally seen within the current environment for financial institutions" were present:

(1) The risk that the residual assets, comprising 40 per cent of Keystone's assets, would not be realized at carrying values (OCC Ex. 76 at GT/F 00701);

(2) The failure of several major subprime lenders similar to Keystone during the past year (1998), resulting from aggressive assumptions in determining gains on sale and liquidity problems (OCC Ex. 76 at GT/F 00701); and

(3) The OCC's dispute of Keystone's conclusion that it was "adequately" capitalized for prompt corrective action ("PCA") purposes under the FDICIA, and the OCC request for adjustments that would force the bank into "undercapitalized" PCA status, resulting in operating restrictions (OCC Ex. 76 at GT/F 00702).

168. At the time that Grant Thornton planned and conducted the audit, and as Grant Thornton's audit expert, Mr. Jay Goldman, acknowledged, multiple fraud-risk factors (set out in GAAS AU 316 (GT Ex. 214)) were present, including:

(1) the failure of management to display and communicate an appropriate attitude regarding internal controls in the financial reporting process,

including domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee (Tr. 3131 (Goldman));

(2) inadequate monitoring of significant controls (Tr. 3131 (Goldman));

(3) the bank's failure to correct known, reportable conditions on a timely basis (Tr. 3132 (Goldman));

(4) the existence of significant tension between management and regulatory authorities (Tr. 3133 (Goldman));

(5) the continued employment by management of ineffective accounting information technology or internal audit staff regarding internal auditing (Tr. 3133 (Goldman)); and

(6) the instability of senior management due to turnover for various reasons. Tr. 3134-3135 (Goldman).

169. Grant Thornton's audit planning memorandum identified the following fraud risk factors:

(1) management has the ability to predetermine net income by increasing the provision for the allowance for loan and lease losses (OCC Ex. 76 at GT/F 00711);

(2) "Terry Church, SVP, is responsible for many facets of the operations with most transactions being approved by her and the issue noted above [ability to predetermine income through manipulation]"; and

(3) the regulatory climate at the bank.

(OCC Ex. 76 at GT/F 00711).

170. Grant Thornton knew that Keystone had experienced significant senior management turnover:

(1) In order to comply with the requirement of the Formal Agreement to hire a chief financial officer ("CFO"), Keystone hired Mr. Mike Shiery. OCC Ex. 76 at GT/F 00702, GT/F 00702.1. Mr. Shiery was replaced by Ms. Jane Carney, who served as acting CFO for only a few weeks (Tr. 3134 (Goldman));

(2) During this time, Keystone employed three presidents (Ms. Billie Cherry, who resigned under pressure from the OCC; Mr. Owen Carney, who served only six weeks and resigned in March 1999 under pressure from Ms. Church; and as of April 1999, Mr. Gary Ellis). Tr. 1780 (Carney), Tr. 3134 (Goldman). Mr. Owen Carney, a retired OCC official, who worked as a consultant to Keystone (Tr. 1778–1779 (Carney)) and later became Keystone's president (Tr. 1862–1863 (Carney)), was effectively fired at the request of Ms. Church because he "asked too many questions." Tr. 664–666 (Gerardy); Tr. 1834–1836, 1856 (Carney).

171. As part of Grant Thornton's pre-audit preparation, Grant Thornton, in December 1998, reviewed Keystone's board of directors minutes and noted that Mr. Knox McConnell (Keystone's president who died in 1997 (GT Ex. 10 at 43)) and Ms. Church had been investigated by the FBI for participating in a kickback scheme involving unearned fees related to real estate appraisals in violation of the Real Estate Settlement Procedures Act ("RESPA").

OCC Ex. 77 at GT/F 03307; Tr. 2340–2342 (Buenger). "Mrs. Church [was] completing appraisals and paying Mr. McConnell to assist." OCC Ex. 77 at GT/F 03307; OCC Ex. 1 at 25; Tr. 2340-2341 (Buenger); Tr. 2033–2034 (Quay).

3. Grant Thornton Neither Planned Nor Conducted A Maximum-Risk Comprehensive Audit

172. In preparing the 1998 audit plan for Keystone, Grant Thornton prepared an environmental risk assessment memorandum, dated December 28, 1998, to determine what procedures were necessary to carry out the audit. OCC Ex. 296 at GT/F 000526.

173. On December 28, 1998, Grant Thornton originally assessed the environmental risk at "slightly below maximum." OCC Ex. 296 at 00524. This assessment also appears as a one-line entry on a separate sheet of paper, dated December 31, 1998: "Based upon the foregoing, an environmental assessment of "slightly below maximum" is deemed appropriate." OCC Ex. 296 at GT/F 00525.

174. An environmental risk assessment of "slightly below maximum" was incorrect because it was not one of three possible ratings under Grant Thornton's environmental risk procedures ("maximum risk," "moderate risk," and "limited risk."). OCC Ex. 327 at 012405.

175. The control-risk assessment also was prepared on December 28, 1998. OCC Ex. 296 at GT/F at 00530. The control risk was assessed at "slightly below maximum," the second of four possible ratings for control-risk ratings, even though Grant Thornton knew that Keystone did not have an internal control function, and that its books and records were unreliable.

176. Grant Thornton's audit manual permitted a reduction in substantive procedures where the environmental assessment was less than "maximum risk" and the control risk was assessed at less than maximum risk. OCC Ex. 327 at GT 012346.

177. Based on the original assessments of the environmental and control risks, Grant Thornton's audit manual permitted Grant Thornton to perform a "B"asic audit. OCC Ex. 326 at GT 012346.

178. The Grant Thornton audit plan for Keystone was dated December 31, 1998 (OCC Ex. 76 at GT/F 00700 (folded behind GT/F 00712) and GT/F 00701).

179. Grant Thornton's audit plan required that: (1) assets serviced by third-party servicers be confirmed by the servicers; and (2) interest income related to those assets be audited through the use of an analytical procedure, called a "test of reasonableness." OCC Ex. 76 at GT/F 00706.

180. The "test of reasonableness" simply compares asset volume and loan characteristics to reported interest income to see if there is a reasonable relationship between the two. Tr. 2718–2719, 2720 (Potter); *see also* Tr. 3018 (Goldman).

181. Unlike a "test of details," a "test of reasonableness" does not attempt to verify that the income is actually being received by the bank. Tr. 2719 (Potter), Tr. 3018 (Goldman).

182. Grant Thornton's audit plan for Keystone was consistent with the description of a "B"asic audit strategy in Grant Thornton's auditing manual, because that type of audit relied upon an analytical test to audit interest income. *Compare* OCC Ex. 76 at GT/F 00706 and OCC Ex. 327 at GT 012344.

183. The audit plan prepared by Grant Thornton for Keystone was also consistent with Grant Thornton's routine audit procedures, because nearly all of Grant Thornton's audits were "Basic" audits and the "test of reasonableness" was the "standard format" used by Grant Thornton in auditing the income statement. Tr. 2408, 2596 (Buenger).

184. Prior to Mr. Quay signing-off in mid-January 1999 on the audit plan (OCC Ex. 76 at GT/F 00700 (folded behind GT/F 00712), Grant Thornton reviewers (Ms. Vorholt and Newton) discussed with Ms. Buenger her assessment of the environmental risk at "slightly below maximum." Tr. 1967-1969 (Quay). As a result of this discussion, the words "slightly below" were crossed-out, leaving the environmental assessment as "maximum" risk. Tr. 1967–1969 (Quay); OCC Ex. 296 at GT/F 00524–GT/F 00525.

185. A "maximum" environmental risk assessment required a maximum risk audit under GAAS, called a "Comprehensive" audit in Grant Thornton's auditing manual, which primarily emphasized "tests of details" not only for asset verification, but for the audit of interest income as well. OCC Ex. 327 at GT 012344–GT/F 012346; GT Ex. 211 (AU 311.03(g); GT Ex. 212 (AU 312.17); GT Ex. 214 (AU 316.12, .23, .27 and .28); GT Ex. 216 (AU 319.04); Tr. 2695 (Potter).

186. The Grant Thornton manual explained that a "Comprehensive" audit was required wherever the "environmental factors, accounting system or control procedures are sufficiently weak to cause the possibility of a material misstatement occurring in the related financial statement account to be high . . . ." OCC Ex. 327 at 012344.

187. Neither Mr. Quay nor Ms. Buenger had been involved in a maximum risk audit under GAAS, referred to as a "Comprehensive" audit in Grant Thornton's auditing manual. Tr. 2277 (Quay); Tr. 2336–2337, 2344 (Buenger).

188. Grant Thornton assessed the audit risk of the Keystone audit at the "maximum." Tr. 2694–2695 (Potter); OCC Ex. 296 at GT/F 00524–GT/F00525.

189. Grant Thornton did not perform a maximum risk "Comprehensive" audit, even though it acknowledged that this audit presented "maximum" risk and its auditing manual required a "Comprehensive" audit in such circumstances. Tr. 2751–2752 (Potter).

H. Grant Thornton's Confirmation Procedures for Loans Reportedly Owned By Keystone But Serviced by Advanta Violated GAAS

190. In late 1998, Compu-Link transferred to Advanta $236 million in United loans, serviced by Advanta under Investor No. 406, and $6.3 million in Keystone loans, serviced by Advanta under Investor No. 405. OCC Ex. 500; OCC Ex. 744 (Ramirez Dep. at 141–143).

191. After the Keystone and United loans were transferred from Compu-Link to Advanta in late 1998, Ms. Patricia Ramirez, the manager of Advanta's investor reporting function, sent e-mails to Keystone and United informing them of their investor numbers, Investor No. 405 and Investor No. 406, respectively. OCC Ex. 744b (Ramirez Dep. at 13–14, 141–143).

192. In a "reconciliation" (also referred to as a "lead schedule," Tr. 2352-2353 (Buenger)), dated January 31, 1999, that was prepared by Ms. Church and provided to Ms. Buenger, Keystone asserted that, as of December 31, 1998, Advanta was servicing $242 million in Keystone loans. OCC Ex. 329 at GT001118; Tr. 2353–2354 (Buenger).

193. GAAS requires that "significant" confirmations be obtained in writing. GT Ex. 218 (AU 330.29); Tr. 2714 (Potter).

194. Because Keystone was reporting that Advanta was servicing $242 million in Keystone loans – approximately twenty-five percent of Keystone's reported assets – Grant Thornton considered the Advanta confirmation to be "primary, critical, significant, and material" to the audit. Tr. 2351, 2389, 2616 (Buenger).

195. The audit plan contemplated that Grant Thornton would verify the bank's ownership of loans reportedly owned by Keystone but serviced by third-party servicers by sending a letter to the servicers requesting that they submit directly to Grant Thornton written confirmations of the loans. OCC Ex. 76 at GT/F 00706

196. GAAS required written confirmation from Advanta. Tr. 2855 (Potter); *see also* Tr. 3035-3036 (Goldman).

197. Grant Thornton sent a confirmation-request letter to Advanta at the end of December 1998. GT Ex. 1F at GT000656.

198. In March 1999, Ms. Buenger, the Grant Thornton project manager assigned to this part of the audit, placed a telephone call to Ms. Ramirez, inquiring about Advanta's response to Grant Thornton's letter seeking confirmation of loans Advanta was servicing for Keystone, and was told by Ms. Ramirez that Advanta had responded in writing to the request in early January 1999. Tr. 2369–2370 (Buenger).

199. Ms. Buenger then faxed to Ms. Ramirez a copy of the confirmation-request letter that had been sent in late December 1998, and asked Advanta to resend its written response. GT Ex. 1C at GT000655; OCC Ex. 329 at GT 000655; Tr. 2369–2370 (Buenger).

200. Within a day or two, Grant Thornton received by Federal Express the same information Advanta had sent in January 1999. OCC Ex. 744b (Ramirez Dep. at 165–170);

Tr. 2369–2373, 2376 (Buenger). Advanta documented in a written confirmation response that it was servicing $6.3 million in Keystone loans – not the $242 million the bank was reporting. GT Ex. 1B at GT 001140; Tr. 2373, 2376-2377 (Buenger). Specifically, Advanta's written response confirmed that, as of December 31, 1998 (the date of significance for purpose of the audit), Advanta was servicing, under Investor No. 405, $6.3 million in loans owned by Keystone. GT Ex. 1B at GT 001140; OCC Ex. 80; Tr. 2375-2377 (Buenger).[3]

201. Ms. Buenger took no immediate action upon receipt of the Advanta confirmation, and, instead, put the response "on the back burner" for several weeks (Tr. 2376 (Buenger)), and she did not mention the discrepancy to Mr. Quay, her direct supervisor on the audit, or to Keystone management. Tr. 2378–2379 (Buenger).

202. On April 7, 1999, Ms. Buenger telephoned Ms. Ramirez about the Advanta confirmation. Tr. 2378–2379 (Buenger). Ms. Buenger and Ms. Ramirez discussed loans being serviced by Advanta. Ms. Buenger and Ms. Ramirez then discussed the best way to get the information they had discussed to Ms. Buenger in writing and decided that Ms. Ramirez would send her an e-mail. Tr. 2379–2380 (Buenger).

203. Within minutes of this conversation, Ms. Ramirez sent Ms. Buenger an e-mail, the text of which was:

From: Ramirez, Patricia [Pramirez@advanta.com]

Sent: Wednesday, April 07, 1999 3:09 PM
To: 'sbuenger@gt.com'

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[3] Grant Thornton also sent a similar letter to Compu-Link asking for confirmation of loans. By letter, dated January 13, 1999, Compu-Link errantly confirmed that it was servicing $227 million in Keystone loans. OCC Ex. 240; Tr. 1160–1161 (Wilson, C.); Tr. 1351–1352 (Blair); GT Ex. 586 (LaRose Dep. at 164–166). In fact, Compu-Link was servicing $14 million in loans owned by Keystone and $213 million in loans owned by United. Tr. 2783 (Potter).

Subject: Inv. 406 12/31/98 figures

Below is the information requested for Inv. 406 as of 12/31/98.

INVESTOR NUMBER	INVESTOR NAME	NUMBER OF LOANS	MONTH END BALANCES
406	UNITED NATIONAL BANK	6,283	236,221,923.07

If you have any questions, please call me at (619) 674-3876.
Patricia Ramirez
Investor Reporting Manager

OCC Ex. 80 at GT/F 0194; Tr. 2380 (Buenger).

204. Under the Advanta record system, the "Investor" was the owner of the loans. OCC Ex. 744b (Ramirez Dep. at 141–148).

205. Ms. Ramirez never mentioned United in her telephone conversation with Ms. Buenger. Tr. 2381 (Buenger). Ms. Buenger had no recollection of a discussion during her telephone conversation with Ms. Ramirez about why the loans were not titled under the name Keystone. Tr. 2381 (Buenger).

206. Ms. Buenger did not ask Ms. Ramirez during the telephone conversation if Advanta was servicing Keystone loans under more than one investor number. Tr. 2400 (Buenger).

207. Given the Keystone/United arrangement, Keystone, of necessity, had access to United loan information. And Ms. Ramirez understood that Keystone and United shared with each other information about their loans. OCC Ex. 744b (Ramirez Dep. at 101-104, 113); *see also* Tr. 1606–1607 (Wilson, J.) (United's Executive Vice President testifying that the provision of information on United loans to Grant Thornton, as Keystone's auditor, was not problematic

because of the contractual relationship United had with Keystone); Tr. 1608 (Wilson, J.) (testifying that United freely shared information about its loans with Keystone).

208. Ms. Ramirez understood that the loans in Investor No. 406 were owned by United. OCC Ex. 744b at 142–143 (Ramirez Dep.); *see also* OCC Ex. 791 (Romero Dep. at 108–109) (testifying that in August 1999 when Mr. Quay called insisting that Keystone owned the loans in Investor No. 406 that she discussed his call with her supervisor, Ms. Ramirez, and "[s]he [Ms. Ramirez] sort of laughed, because there's no doubt in our minds, the investor number is such an integral part of how we service loans, it's the thing that drives where payments go, where remittances go. There's no question of that ever being inaccurate . . . Before we even board loans, the various parties, the client, as well as the prior servicer, sign off on the balance, the number of loans, and the balance within investor number populations, if there are more than one. So it's just ridiculous for it to be – for him to think it was otherwise"); OCC Ex. 791 (Romero Dep. at 217–220, 245–250); OCC Ex. 745b (Burke Dep. at 12–15).

209. Ms. Ramirez could not recall an instance where she had been confused about who owned loans serviced under a particular investor number, or an instance where loans were mis-coded by Advanta. OCC Ex. 744b (Ramirez Dep. at 143–144, 189).

210. It was a requirement of Ms. Ramirez's employment to know who owned the loans under any particular investor number. OCC Ex. 744b (Ramirez Dep. at 188–189).

211. Third-party asset servicers, such as Advanta, are fairly sophisticated and understand requests such as the one Ms. Buenger made regarding Keystone because they respond to similar requests routinely. Tr. 2997 (Goldman).

212. Ms. Buenger did not follow-up with Ms. Ramirez or anyone else at Advanta about the April 7, 1999 e-mail, stating that Advanta was servicing $236 million in loans for United, or the March 1999 written confirmation response, stating that Advanta was servicing $6.3 million in loans for Keystone. Tr. 2384, 2378–2384 (Buenger).

213. Ms. Buenger concluded that Advanta was servicing $242 million in Keystone loans. Ms. Buenger added the $236 million from Investor No. 406 (United) to the $6.3 million from Investor No. 405 (Keystone) and concluded that Keystone owned $242 million in loans being serviced by Advanta. Tr. 2385 (Buenger); Tr. 3115 (Goldman); OCC Ex. 80 at GT/F 01094.

214. Ms. Buenger made a notation of her telephone conversation with Ms. Ramirez on a folder flap: "Per discussion with Patricia Ramirez at (619) 674-3876, the loans coded under the 'United' name actually belonged to Keystone as of December 31, 1998." GT Ex. 1B at GT 001139; OCC Ex. 80 at GT/F 01096.

215. Grant Thornton's reliance upon Ms. Buenger's telephone conversation with Ms. Ramirez at Advanta violated GAAS because it was an "oral confirmation" – not a written confirmation as required for "significant" assertions. Tr. 2714–2715 (Potter).

216. Grant Thornton failed to obtain sufficient, competent evidence in connection with its attempt to confirm assets Advanta was servicing for Keystone. Tr. 2718 (Potter). The evidence not only demonstrated that Keystone owned only $6.3 million in loans, but also demonstrated that it did not own $236 million in the loans it was reporting. Tr. 2929–2930 (Potter). Grant Thornton failed to exercise professional skepticism in connection with the Advanta confirmation process. Tr. 2715 (Potter).

217. Had Grant Thornton followed GAAS procedures, it most likely would have discovered the true financial condition of Keystone. Tr. 2734-2735, 2754–2756 (Potter) ("fraud was staring them in the face").

I. Grant Thornton's Audit of the $98 Million in Reported Interest Income from Loans Reportedly Owned by Keystone But Serviced by Third-Parties

218. For 1998, Keystone represented that it received approximately $98 million of interest income from assets serviced by third-parties who specialized in servicing loans owned by other financial institutions. OCC Ex. 294 at GT 001299; Tr. 2406 (Buenger). The audit of this interest income was "exceptionally important" because it "dwarfed" any other number on the income statement. Tr. 2720 (Potter).

219. In auditing the reported interest income from loans serviced by third-party servicers, Grant Thornton relied upon summaries and reports prepared by bank management. Grant Thornton did not directly verify the income into the bank's records. Tr. 2406– 2407 (Buenger).

1. GAAS Required a "Test of Details"

220. A "test of details" in verifying Keystone interest income serviced by third-party servicers would have been both effective and efficient, within the meaning of GAAS, because in 1998 most of the loans were reportedly serviced by Compu-Link, which remitted interest income on a monthly basis. Tr. 2723–2725 (Potter).

221. The remittances from the servicers, including Compu-Link, were available either at Keystone or the servicers. Tr. 2723–2725 (Potter); OCC Ex. 159 at 2; OCC Ex. 744b (Ramirez Dep. at 153–154).

222. Ms. Buenger could have requested the Compu-Link remittances from Ms. Tammy Semonco.[4] Tr. 2510 (Buenger).

223. Mr. Quay employed a "test of details" to verify that Keystone was receiving the interest income on its residual assets that it was reporting for 1998. Tr. 2514–2515 (Buenger); Tr. 2722 (Potter); Tr. 3087 (Goldman).

224. At the time the fraud was discovered in late August 1999, Grant Thornton auditors used a "test of details" (a review of monthly remittances) to determine that Keystone had not been receiving interest income in connection with loans serviced by third parties sufficient to support the $98 million in income the bank had been reporting. Tr. 2570 (Buenger); Tr. 2090–2091, 2094 (Quay).

225. Grant Thornton did not follow the requirements of its audit manual to conduct a "Comprehensive" audit that called for primary reliance upon a "test of details" in connection with the audit of interest income from loans serviced by third-party servicers. Tr. 2724–2725 (Potter).

226. Performing a "test of details" involving the review of monthly remittances from the asset servicers is a simple procedure that would have taken less than an hour. OCC Ex. 300 (workpapers for test related to income residual interests); Tr. 1974-1975 (Quay); Tr. 2504 –2506 (Buenger); Tr. 2721–2722 (Potter).

227. Had a "test of details" been performed, Grant Thornton would have discovered the true financial condition of the bank. Tr. 2722–2724, 2725, 2734–2735, 2897 (Potter);

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[4] At the time Ms. Semonco was deposed in connection with this proceeding her name by marriage was Ms. Tammy Terry. OCC Ex. 747A at 7–8 (Terry).

Tr. 2507–2710 (Buenger); OCC Ex. 742b (Hall Dep. at 142–143, 188–189); OCC Ex. 747b (Terry Dep. at 14–18, 31–33, 39–43).

2. **The Analytical Test of Income Based Upon Bank Generated <u>Documents and Call Reports Did Not Satisfy GAAS Requirements</u>**

228. An analytical test to audit Keystone's reported interest income from loans serviced by third-party servicers was not appropriate under GAAS because the documents necessary to perform a test of details were readily available at the bank, or could have been obtained directly from the servicers. Tr. 2722–2724, 2725, 2734–2735, 2897 (Potter); Tr. 2507–2710 (Buenger); OCC Ex. 742b (Hall Dep. at 142–143, 188–189); OCC Ex. 747b (Terry Dep. at 14–18, 31–33, 39–43); OCC Ex. 744b (Ramirez Dep. at 153–154); OCC Ex. 781 (AU 329.12).

229. When an entity has poor internal controls, a "predictive" test (such as the "test of reasonableness" that Grant Thornton performed) can be manipulated by management in order to achieve the result the client wants, as opposed to what is actually true. Tr. 2891–2892 (Potter).

230. Before an analytical test could be used for substantive purposes in place of a "test of details," GAAS, as described in Grant Thornton's auditing manual, required Grant Thornton's auditors to identify and describe the internal controls pertinent to the assertions to be audited, test the controls to be relied upon, and re-evaluate such controls in light of the results to determine if reliance would be warranted. OCC Ex. 296 at GT/F 00529.

231. Consistent with GAAS, the OTS Order required that Grant Thornton's "audit plan shall include the plan for identifying and testing internal controls for the purpose of determining the nature, timing, and extent of the substantive tests to be performed." OCC Ex. 4 at 6.

232. Where an entity's internal controls have not been tested for reliability, GAAS imposes a duty upon the auditor to independently verify all financial data generated internally or otherwise provided by the client's management before that data may be used for auditing purposes. Tr. 3057-3058 (Goldman); Tr. 2729-30 (Potter); GT Ex. 216 (AU 319.65).

233. According to Grant Thornton's audit manual: "The analytical approach minimizes tests of details on the assumption that environmental factors, the accounting system and control procedures are sufficiently strong to allow us to accept maximum detection risk. . . . The analytical approach places significant emphasis on understanding and testing of the client's internal control system." OCC Ex. 327 at GT 012344.

234. Where an auditor has investigated an entity's internal control design and determined that it is, in fact, in place, GAAS permits a reduction in the use of substantive testing in carrying-out the audit. GT Ex. 212 (AU 312.16). However, where an auditor knows that the internal controls are lacking either in design or execution, GAAS does not permit the auditor to rely upon the controls, and the auditor must employ tests of transactions and conduct additional evaluations in order to acquire needed competent evidence to support its opinion. GT Ex. 212 (AU 312.16).

235. Because Keystone's internal controls and accounting data were unreliable, in order to use an analytical test in connection with Keystone's interest income, GAAS required Grant Thornton to test for accuracy all financial data provided by Keystone's management. Tr. 3058 (Goldman); Tr. 2729-30 (Potter); GT Ex. 216 (AU 319.65).

236. Grant Thornton's "test of reasonableness," which was completed on March 5, 1999, relied upon a schedule prepared by Mr. Graham (OCC Ex. 294) (the "Graham schedule"),

and Keystone Call Reports, prepared by Ms. Church, that purportedly contained monthly asset and interest income totals for 1998, but Grant Thornton did not test for reliability any of the financial data in the Graham schedule or any other financial data obtained by Grant Thornton from Keystone employees. Tr. 2407, 2410–2412 (Buenger).

237. Ms. Buenger used data from the Graham schedule in Grant Thornton's "test of reasonableness" even though she was aware that at least some of the data in the Graham schedule was inaccurate, was inconsistent with Grant Thornton's understanding of Keystone's operations, or was inconsistent with other data obtained from the bank, in that:

(1) it did not reflect the May and September 1998 securitizations, which, under Grant Thornton's understanding of Keystone's securitization program, should have resulted in dramatic decreases in loans serviced by third-party servicers (Tr. 2417–2418 (Buenger));

(2) the average monthly yields remained constant from month to month within each quarter, even though one would expect the yields to be different each month (Tr. 2418–2419 (Buenger)); and

(3) the numbers in the Graham schedule did not match the numbers given to Grant Thornton by Keystone management in connection with a reconciliation of the general ledger as of June 30, 1998, which had been undertaken as part of the accounting procedures required under the Formal Agreement (Tr. 2422–2423 (Buenger)).

238. Ms. Buenger did not attempt to correlate the numbers on the Graham schedule to other work Grant Thornton had done because the schedule did not make sense to her as an auditor. Tr. 2421–2422 (Buenger).

239. Ms. Buenger used six numbers from the Graham schedule for the "test of reasonableness," namely the "held for sale" and "portfolio" loan balances for January, February, and March 1998. Tr. 2424 (Buenger).

240. A handwritten note on the Graham schedule by Ms. Buenger states that she used the average loan balance from the worksheet because it was the best available information inasmuch as Keystone was restating its inaccurate Call Reports at the direction of the OCC. Tr. 2425 (Buenger).

241. The Graham schedule was "absolutely not" sufficient, competent evidentiary matter to support the interest income from third-party servicers that Keystone was reporting. Tr. 2491 (Buenger).

242. Grant Thornton understood that the use of erroneous data to perform the "test of reasonableness" would affect its reliability. Tr. 2428 (Buenger).

243. The analytical "test of reasonableness" performed by Grant Thornton in connection with the audit of the bank's reported interest income associated with loans serviced by asset servicers was not a substantive test. Tr. 2721 (Potter).

244. The analytical "test of reasonableness" was not "strong." Tr. 2721 (Potter).

3. The Analytical Test Based upon the Purported December 1998 Remittance Deviated From GAAS in Several Respects

245. Because Grant Thornton had concerns about the reliability of the "test of reasonableness" based upon the Graham schedule and the Call Reports (Tr. 2416–2429

(Buenger)), Grant Thornton conducted a second "test of reasonableness" based upon a purported Compu-Link remittance for December 1998. OCC Ex. 295 at GT/F 01223; Tr. 2491–2492, 2502-2503 (Buenger). In performing the "test of reasonableness," Ms. Buenger took the December 1998 interest income figure and annualized it in order to estimate Keystone's total 1998 interest income from loans serviced by third-party servicers over the other eleven months of 1998. Tr. 2502-2503 (Buenger).

246. Ms. Buenger obtained the purported Compu-Link remittance for December 1998 from an employee of the bank, named Ms. Watkins, but could not remember whether or not she asked for it specifically to conduct the test or just saw it on Ms. Watkins's office chair and asked her for a copy of it. Tr. 2492 (Buenger).

247. The purported Compu-Link remittance obtained by Ms. Buenger was a one-page document, attached to a one-line letter from a Compu-Link accountant, Mr. Forrest Krum, that stated: "Enclosed please find a detailed trial balance for the month ending December 31, 1998. The payments received in December 1998 have been forwarded to you." OCC Ex. 295 at GT/F 01222.

248. A "trial balance" was not attached to the Krum letter. Tr. 2494–2498 (Buenger). A "trial balance" would have been a very voluminous document because of the large number of loans Keystone was reporting. Tr. 2494–2498 (Buenger).

249. Ms. Buenger did not ask Ms. Watkins or anyone else at Keystone for the trial balance that was supposedly attached. Tr. 2494–2495, 2498 (Buenger).

250. The remittance was not on Comp-Link letterhead and did not otherwise indicate that Compu-Link generated it. Tr. 2493–2494 (Buenger).

251. Grant Thornton ignored criteria for assessing reliability of data used in analytical tests for substantive purposes, listed in OCC Ex. 781 (AU 329.16), when it relied upon financial data obtained from Keystone management to perform its two tests of reasonableness without independently reviewing that data for accuracy. Tr. 2874–2876, 2893 (Potter).

J. The Issuance of Grant Thornton's Audit Opinion, Discovery of the Fraud, and Closing of Keystone

252. GAAS is designed to protect users of audited financial statements by increasing the likelihood that auditors will identify material misstatements whether caused by error or fraud. Tr. 2725 (following GAAS would have uncovered the fraud at Keystone), 2927 (Potter).

253. In April 1999, Grant Thornton issued an audit report for Keystone's 1998 financial statements that stated that the audit had been conducted pursuant to GAAS and that Grant Thornton had obtained reasonable assurance that the bank's financial statements were free from material misstatements. OCC Ex. 311 at 017611-0376.

254. In July 1999, in reliance upon Grant Thornton's unqualified audit, Keystone's board of directors voted to declare, and subsequently paid, dividends to its shareholders of approximately $1 million. Tr. 2753 (Potter); Tr. 1458 (Budnick); OCC Ex. 789 (Kaufman Dep.at 184–186); OCC Ex. 318 at 011812–004.

255. In August 1999, the OCC examiners requested and obtained information directly from the servicers (including Advanta), despite efforts by Keystone management to prevent disclosure, showing that Keystone was vastly overstating its assets. OCC Ex. 155; OCC Ex. 158; OCC Ex. 159; OCC Ex. 164; OCC Ex. 531; OCC Ex. 529.

256. In August 1999, after the OCC examiners obtained information calling into question Keystone's ownership of loans being serviced by third-party servicers, Mr. Quay

performed a calculation similar to the "test of reasonableness" conducted earlier by Ms. Buenger in connection with the audit but determined that the analytical approach was inadequate. Tr. 2562–2563 (Buenger). Mr. Quay stated that the way to resolve the issue was by looking at the remittances. Tr. 2563 (Quay).

257. On August 26, 1999, Ms. Buenger asked for a "general ledger history" of interest income and identified several large entries. Tr. 2564 (Buenger). She asked a bank employee, Ms. McKinney, to provide her with support for those entries. Tr. 2564–2564 (Buenger). Because there was a delay in this information being provided to her, she decided to look through the "general ledger tickets" for supporting documentation for those entries she had identified as potentially significant. Tr. 2565 (Buenger). This approach failed to uncover any support for the assets and income Keystone was reporting. Tr. 2564–2565 (Ms. Buenger). Ms. Buenger observed that it seemed as though "big chunks of days or something was missing." Tr. 2565 (Buenger).

258. On August 30, 1999, Mr. Quay and Ms. Buenger asked and received the Compu-Link remittances from a bank employee, Ms. Tammy Semonco. Tr. 2507–2508, 2569–2570 (Buenger), OCC Ex. 744b (Terry Dep. at 42–44). The Compu-Link remittances supported approximately $6 million in Keystone loans. Tr. 2507–2509, 2570 (Buenger); Tr. 1285–1287 (Blair); Tr. 2090 –2091 (Quay).

259. In all, Keystone had overstated its 1998 interest income by nearly the entire $98 million and its 1998 assets by approximately $450 million (about fifty percent of total reported assets). Tr. 2780, 2783 (Potter); Tr. 1583 (Wilson, J.).

260. After the fraudulent overstatement of assets and income was uncovered, the OCC determined that the bank was insolvent and appointed the FDIC as receiver on September 1, 1999. OCC Ex. 170; OCC Ex. 171; and OCC Ex. 172.

261. Subsequently, a group of Keystone insiders, including Ms. Church and Mr. Graham, received felony convictions for, among other things, obstruction of the OCC's 1998 bank examination, bank embezzlement, and money laundering. Tr. 359 (Schneck). *See, e.g.*, *United States v. Cherry*, 330 F.3d 658 (4th Cir. 2003); and *United States v. Church*, 2001 WL 585108 (4th Cir. 2001).

Conclusions of Law

1. Within the meaning of 12 U.S.C. § 1813(u) Grant Thornton acted as an institution- affiliated party ("IAP") in planning and conducting the audit of Keystone's 1998 financial statements:

(1) GAAS provided the standard of care for Grant Thornton in planning and conducting the audit;

(2) Grant Thornton violated GAAS in auditing Keystone's reported ownership of assets serviced by third-party asset servicers in 1998;

(3) Grant Thornton violated GAAS in auditing interest income Keystone reported in connection with its claimed ownership of assets serviced by third-party asset servicers in 1998;

(4) Grant Thornton participated in an unsafe or unsound practice when it violated GAAS in planning and conducting the audit of Keystone's 1998 financial statements;

(5) Grant Thornton's participation in the unsafe or unsound practice was reckless because Grant Thornton, knowing of all of the circumstances that made the Keystone audit a maximum risk audit, planned and conducted its audit of Keystone in a manner that demonstrated a disregard of, or conscious indifference to, the known or obvious risk of harm that would occur from failing to comply with GAAS's requirements in those circumstances;

(6) Grant Thornton's participation in the unsafe or unsound practice caused more than a minimal financial loss to, or a significant adverse effect on, Keystone by facilitating Keystone's payment of $1 million in dividends after Grant Thornton's audit opinion was issued.

2. Within the meaning of 12 U.S.C. § 1818(b)(1), Grant Thornton, as an IAP, engaged in an unsafe or unsound practice in conducting the business of an insured depository institution, Keystone, through its multiple violations of GAAS in planning and conducting the audit of Keystone's 1998 financial statements and, therefore, the imposition upon Grant Thornton of a C&D is warranted.

3. Within the meaning of 12 U.S.C. § 1818(i)(2)(B)(II), Grant Thornton, as an IAP, recklessly engaged in an unsafe or unsound practice in conducting the affairs of an insured depository institution, Keystone, through its multiple violations of GAAS in planning and conducting its audit of Keystone's 1998 financial statements, knowing of all the circumstances that made its audit a maximum risk audit, and knowing the risk of harm to Keystone and other users of the audit from failing to comply with GAAS. Upon consideration of the factors set forth

in 12 U.S.C. § 1818(i)(2)(G), imposition of a second tier CMP in the amount of $300,000 is appropriate.

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

IN THE MATTER OF:	)	
Grant Thornton LLP	)	
External Auditor For	)	**AA-EC-04-02**
The First National Bank of Keystone	)	
Keystone, West Virginia	)	

ORDER TO CEASE AND DESIST

The Comptroller of the Currency ("Comptroller") has issued a Final Decision in this matter finding that Grant Thornton LLP ("Grant Thornton"), is an institution-affiliated party, within the meaning of 12 U.S.C. § 1813(u)(4), and that Grant Thornton recklessly "engaged" in an unsafe or unsound practice "in conducting the business of" the First National Bank of Keystone, Keystone, West Virginia, within the meaning of 12 U.S.C. § 1818(b)(1). Therefore, in accordance with the findings and conclusions of the Final Decision in this matter, the Comptroller orders that Grant Thornton comply with the following:

ARTICLE I

Acceptance of Insured Depository Institution Engagements

(1) Prior to agreeing to perform an audit for an insured depository institution for the first time, Grant Thornton shall document and retain:

(a) The reasons provided for the change in auditors, including the specific nature of disagreements, if any, between the predecessor auditor and the prospective audit client;

(b) A preliminary assessment of audit risks, the specific steps taken in designing the scope of the audit to address those risks as required by AU

§§ 312 and 316, and an estimate of the hours of work required to perform the audit in light of these risks; and

(c) Its determination that the required technical expertise is available within Grant Thornton and the identity of the Grant Thornton personnel who have expertise in areas, if any, which present significant technical complexity. If such expertise is not available at the office leading the engagement, Grant Thornton shall specify persons or offices within Grant Thornton that have the necessary expertise. Grant Thornton shall decline any engagement if the required technical expertise is not available within its organization.

ARTICLE II

Conduct of Insured Depository Institution Engagements

(1) Grant Thornton shall require that an Audit Engagement Partner and an Impartial Reviewer, who shall concur with the Audit Engagement Partner in the audit opinion, perform the procedures described in this Article II with respect to each insured depository institution audit engagement undertaken by Grant Thornton.

(2) *Audit Engagement Partner*. The Audit Engagement Partner shall review and approve audit plan documentation before any significant audit procedures are performed. The audit plan documentation shall be completed after performing an assessment of the risks associated with the client. The risk assessment shall include an assessment of the risk that errors, fraud, and irregularities may cause the financial statements to contain a material misstatement and, based on that assessment, Grant Thornton shall design the audit to provide reasonable

assurance of detecting errors, fraud, and irregularities that are material to the financial statements in accordance with AU § 316. The risk assessment also shall include obtaining an understanding of the institution's internal control structure, including its loan underwriting policies. The audit plan shall include the plan for identifying and testing internal controls for the purpose of determining the nature, timing, and extent of the substantive tests to be performed. The Audit Engagement Partner shall be responsible for determining that the audit is conducted in accordance with GAAS and the audit plan, as appropriately modified and approved in response to information obtained during the course of the audit, and shall be satisfied that the audit is conducted with an independence in mental attitude and due professional care as required by AU § 150. The Audit Engagement Partner shall be responsible for determining that:

(a) sufficient competent evidential matter is obtained to afford a reasonable basis for an opinion regarding the financial statements under audit, as required by AU § 150; and

(b) the documentation referred to in Article IV of this Order has been prepared and included in the working papers.

(3) In addition, the Audit Engagement Partner shall review and approve the following:

(a) a summary of significant matters;

(b) important working papers, including related consultation memoranda, in technically difficult or highly judgmental areas;

(c) documentation of external confirmation of all assets of the institution valued in excess of $100 million dollars; and

(d) other working papers the Audit Engagement Partner considers necessary to obtain a clear understanding of the accounting, auditing, and reporting matters discussed in the summary of significant matters.

(4) *Impartial Reviewer*. Each audit of an insured depository institution must be reviewed by an Impartial Reviewer. For insured depository institutions with assets in excess of $250,000,000, the Impartial Reviewer shall be a partner and shall perform all the functions set forth in this paragraph (4). However, for insured depository institutions with assets not in excess of $250,000,000, the Impartial Reviewer need not be a partner and need not perform the function set forth below in paragraph (4)(a). In reviewing each audit of an insured depository institution, the Impartial Reviewer shall:

(a) review and concur with conclusions in the key working papers (including the audit plan documentation) relating to significant accounting, auditing, and reporting matters, as considered appropriate;

(b) review and concur with the conclusions in the summary of significant matters after discussing with the engagement team any significant accounting, auditing, and reporting matters; and

(c) review and concur with the conclusions in additional working papers considered necessary by the Impartial Reviewer based upon the reviews described in (a) or (b) above.

(5) Before the issuance of an opinion by Grant Thornton, the Audit Engagement Partner and Impartial Reviewer shall sign the Grant Thornton Report Guide sheet or other similar document. Completion of this document shall indicate that the Audit Engagement Partner has

concluded, and that the Impartial Reviewer concurs with the Audit Engagement Partner's conclusion, that:

(a) the audit was performed in accordance with GAAS;

(b) the application of GAAP to significant accounting or reporting matters was proper;

(c) the issuance of Grant Thornton's report on the financial statements is approved; and

(d) the audit was performed in compliance with the terms of this Order in all respects material to the financial statements.

(6) Grant Thornton shall perform audits of insured depository institutions in accordance with GAAS, including:

(a) making appropriate use of audit procedures that give due consideration to the possibility that the substance of a particular transaction may be materially different from its form and that acknowledge that GAAP recognizes the importance of reporting transactions and events in accordance with their substance as described in AU § 411; and

(b) following the hierarchy of established accounting principles as set forth in paragraph AU § 411. If, due to new developments such as legislation or the evolution of a new type of business transaction, there are no established accounting principles for reporting a specific transaction or event, then Grant Thornton shall give consideration to whether it might be possible to report the event or transaction by selecting an accounting

principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event in accordance with AU § 411.

(7) In conducting audits of insured depository institutions, Grant Thornton shall obtain sufficient competent evidential matter through independent inspection, observation, and confirmation, and written representations from the client, so as to afford a reasonable basis for an opinion regarding the financial statements under audit in accordance with AU § 326.

(8) *Confirmations*. Grant Thornton shall ensure that confirmations it performs as part of audits for insured depository institutions are in accordance with GAAS, including but not limited to AU § 330. Grant Thornton shall, in accordance with GAAS, obtain and retain written documentation provided by persons or businesses other than the client sufficient to verify the ownership of assets as part of the working papers for that audit or engagement. Additionally, when oral representations by a confirming party or its representative alter the substance of a confirmation, Grant Thornton shall procure written verification and explanation of this alteration from the confirming party.

(9) In performing an audit of an insured depository institution, Grant Thornton shall, in accordance with GAAS, take such steps as are necessary to gain an understanding of all financial relationships between the institution and other persons or entities that have or could reasonably be expected to have a material effect on the financial statements of the institution.

(10) Each audit of the financial statements of an insured depository institution by Grant Thornton shall include, in accordance with GAAS:

(a) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

(b) procedures designed to identify related-party transactions that are material to the financial statements or otherwise require disclosure therein; and

(c) an evaluation of whether there is substantial doubt about the ability of the institution to continue as a going concern during the ensuing fiscal year.

(11) If, in the course of conducting an audit of an insured depository institution, Grant Thornton detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the institution) has or may have occurred, the firm shall, in accordance with GAAS:

(a) determine whether it is likely that an illegal act has occurred; and

(b) if so, determine and consider the possible effect of the illegal act on the financial statements of the institution, including any contingent monetary effects, such as fines, penalties, and damages; and

(c) as soon as practicable, inform the appropriate level of the management of the institution and assure that the audit committee of the institution, or the board of directors of the institution in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of Grant Thornton in the course of the audit, unless the illegal act is clearly inconsequential.

(12) If, after determining that the audit committee of the institution, or the board of

directors of the institution in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such institution, Grant Thornton concludes that:

(a) the illegal act has a material effect on the financial statements of the institution;

(b) the senior management of the institution has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(c) the failure to take remedial action is reasonably expected to warrant departure from a standard audit report by Grant Thornton, when made, or warrant resignation from the audit engagement,

Grant Thornton shall, as soon as practicable, directly report its conclusions to the board of directors of the institution.

(13) When Grant Thornton performs an audit for an insured depository institution, Grant Thornton shall timely report to the audit committee of the institution (or to the board of directors, if the institution does not have an audit committee):

(a) all critical accounting policies and practices to be used;

(b) all alternative treatments of financial information within GAAP that have been discussed with management officials of the institution, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by Grant Thornton; and

(c) other material written communications between Grant Thornton and the management of the institution, such as any management letter or schedule of unadjusted differences.

(14) Grant Thornton shall not permit an accountant associated with the firm to participate in any manner in an audit or the performance of non-audit services for an insured depository institution if that accountant has been censured or denied (temporarily or permanently) the privilege of appearing or practicing before the Securities and Exchange Commission pursuant to 15 U.S.C. § 78d-3, unless, prior to that accountant performing any services for the institution, Grant Thornton:

(a) notifies the insured depository institution of the action of the Securities and Exchange Commission with respect to the accountant; and

(b) obtains the written consent of the audit committee of the institution (or, if there is no audit committee, of the board of directors of the institution) to have the accountant perform specified services for the institution.

ARTICLE III

Minimum Accountant Qualifications

(1) Grant Thornton shall ensure that accountants (including Audit Engagement Partners, Impartial Reviewers, senior managers, and managers) assigned to perform accounting services for or audits of insured depository institutions have sufficient skill, professional competence, and experience in relevant matters to perform each of the tasks undertaken by them competently and in accordance with GAAP and GAAS, as applicable.

ARTICLE IV

Working Papers

(1) Grant Thornton shall preserve all working papers (as described in AU § 339) prepared in connection with audit, accounting, or consulting work, all engagement planning documentation, and all papers (including e-mails) documenting the acceptance of insured depository institution audit engagements, including those presently held by Grant Thornton and those generated in the future, for a period of six (6) years from the end of the fiscal period in which the audit or service performed for the insured depository institution was concluded. This paragraph does not apply in connection with audit or other services commenced prior to sixty (60) days from the date of this Order.

(2) Grant Thornton shall promptly provide reasonable and prompt access to its working papers at the request of the appropriate banking agency or the Federal Deposit Insurance Corporation ("FDIC"), and shall provide, at its own expense, copies of its working papers at the request of the appropriate banking agency or the FDIC.

(3) Grant Thornton's working papers for all insured depository institution audit engagements:

(a) shall be designed to meet the circumstances of a particular engagement and constitute the principal record of the work that Grant Thornton has performed and conclusions that it has reached concerning significant matters. However, as permitted by AU § 339, Grant Thornton may support its report by other means in addition to working papers; and

(b) shall document the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement, including facts obtained during interviews with insured depository institution personnel and responses to significant issues identified during the review of the working papers.

(4) If working papers are modified, altered or supplemented after forty-five (45) days from the issuance of an audit opinion, then as soon as is practicable, such changes shall be clearly identified and the reason for the changes explained in a document to be retained with the supplemental working papers and signed and dated by the person making the change and the person approving such change. In implementing this paragraph, Grant Thornton shall take steps to limit access to working papers following the completion of an audit or engagement.

ARTICLE V

Peer Review

(1) Grant Thornton shall provide a copy of this Order to any accounting firm that performs a peer review of its accounting operations, including any review performed in accordance with 12 U.S.C. § 1831m(g)(3). Grant Thornton shall retain documentation indicating that this Order was provided to any peer review firm for five (5) years following such review.

ARTICLE VI

Implementation of Order

(1) Each provision in this Order shall be effective thirty (30) days after the date of this Order unless otherwise stated in this Order, and shall remain in effect for six (6) years from this effective date unless altered or terminated by the Comptroller.

(2) Any communications or documents required by this order shall be sent to the Office of the Comptroller of the Currency, 250 E Street S.W., Washington, D.C., 20219, to the attention of the Director, Enforcement and Compliance Division ("Enforcement Director"), unless otherwise stated. Any request for modification or termination of this Order shall be delivered to the same address.

(3) Within thirty (30) days of the effective date of this Order, Grant Thornton shall provide to the Enforcement Director documentation of procedures designed to implement the directives contained in this Order, including documents evidencing that the appropriate officials or governing bodies within Grant Thornton have approved those procedures.

(4) Beginning sixty (60) days after the effective date of this Order, Grant Thornton shall not provide any services to insured depository institutions unless those services are performed in accordance with the provisions of this Order. To the extent that this Order addresses matters included within Grant Thornton's present policies, Grant Thornton shall continue to require adherence to those policies consistent with the terms of this Order.

(5) Nothing in this Order shall be construed to relieve Grant Thornton of the obligation to comply with all laws, rules or regulations applicable to any audit or accounting engagement, including but not limited to Title 15 of the United States Code (including 15 U.S.C. § 78j-1) for insured depository institutions that are "issuers" within the meaning of Title 15. To the extent any provision of this Order conflicts with the requirements of Title 15, the requirements of Title 15 shall prevail.

(6) Grant Thornton shall require each Grant Thornton accountant, at or prior to the

time the accountant is initially assigned to perform services for an insured depository institution client, to read a copy of this Order and acknowledge in writing that he or she has done so. Grant Thornton accountants who are performing services for insured depository institutions as of the effective date of this Order must read a copy of the Order and acknowledge in writing that he or she has done so no later than twenty (20) days after the effective date of this Order. Grant Thornton shall retain copies of the acknowledgments described above until six (6) years after the termination of the Order.

(7) Grant Thornton shall not participate in, or aid and abet, any violations of law, breaches of fiduciary duty, or unsafe or unsound practices (as that term is used in Title 12, Section 1818 of the United States Code) with respect to any insured depository institution for which it provides services.

ARTICLE VII

Definitions

(1) The term "appropriate banking agency" includes the "appropriate Federal banking agency," as well as the "State bank supervisor" when applicable, as those terms are defined in Title 12, Section 1813, of the United States Code.

(2) "AU" means United States Professional Auditing Standards promulgated by the Auditing Standards Board of the AICPA.

(3) "Audit" or "audit engagement" means an audit of financial statements performed in accordance with GAAS and includes written opinions issued as a result of such audits.

(4) "Audit Engagement Partner" means the partner or other employee of Grant

Thornton, whether or not so denominated by Grant Thornton, charged with the responsibilities of the Audit Engagement Partner set forth in Article II above.

(5) "GAAP" is defined as the Generally Accepted Accounting Principles, as defined and described by AU § 411 issued by the AICPA, and shall include subsequent modifications, amendments, and changes thereto.

(6) "GAAS" is defined as the Generally Accepted Auditing Standards, as defined by AU § 150 issued by the AICPA, shall include subsequent modifications, amendments, and changes thereto, and shall include auditing standards promulgated by the Public Company Accounting Oversight Board ("PCAOB"), if and when applicable.

(7) "Grant Thornton" means Grant Thornton LLP, and all predecessor and successor organizations.

(8) "Impartial Reviewer" means the partner or employee of Grant Thornton charged with the responsibilities of the Impartial Reviewer set forth in Article II above.

(9) "Insured depository institution" shall have the meaning provided in 12 U.S.C. § 1813(c)(2) ("Insured depository institutions"), and shall also include credit unions as defined in 12 U.S.C. § 1752(1), entities identified in 12 U.S.C. § 1813(c)(3), and any subsidiaries of such institutions or entities; and shall also include any bank holding company as defined in 12 U.S.C. § 1841(a) and any savings and loan holding company as defined in 12 U.S.C. § 1467a(a)(D)-(F). "Institution" shall have the same meaning.

IT IS SO ORDERED, this __7th__ day of December, 2006.

/s/

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JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY