

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

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

**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. Obligation to Understanding Operational Characteristics**

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. The "Due Professional Care" Standard**

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. Audit Risk Assessment

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. Analytical Procedures**

66. An analytical procedure is a process where 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.<sup>1</sup>

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<sup>1</sup> 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).<sup>2</sup>

**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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<sup>2</sup> 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:

<u>ABC Audit Strategy Matrix</u>				
<u>Environmental Risk Assessment</u>	<u>Control Risk Assessment</u>			
	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:

<u>Type of Procedures Emphasized: Test of Details or Analytical</u>		
<u>ABC Approach</u>	<u>Balance Sheet</u>	<u>Income Statement</u>
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).<sup>3</sup>

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](mailto:Pramirez@advanta.com)]  
Sent: Wednesday, April 07, 1999 3:09 PM  
To: 'sbuenger@gt.com'

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<sup>3</sup> 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 miscoded 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.<sup>4</sup> 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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<sup>4</sup> 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 Documents and Call Reports Did Not Satisfy GAAS Requirements**

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 Compu-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 (4<sup>th</sup> Cir. 2003); and *United States v. Church*, 2001 WL 585108 (4<sup>th</sup> 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.