**Notes on Major Case 1**

**Adelphia Communications Corp**

This case discusses a complex and high risk audit engagement. The auditors had to consider related party transactions and their effect on the application of GAAP and footnote disclosures. The case deals with the ethical obligations of management of Adelphia and the auditors.

**Ethical Issues (Overview):** Deloitte and Dearlove, the audit engagement partner, had a duty and obligation of due care in conducting the audit; to approach the audit with a healthy dos of skepticism; and to identify risks of possible problems with the clients’ business model or the existence of material misstatements in the financial statements. The auditors failed on all accounts.

The actions by Deloitte and Dearlove were motivated by egoism and the clients’ best interests, not the interests of the shareholders and creditors. The auditors failed in their public interest obligations. The actions of Rigas management were designed to promote their interests regardless of the cost and ethics of accounting and financial reporting techniques. Using rule-utilitarianism, GAAP and GAAS must be followed regardless of any utilitarian benefits that may exist for the company by developing its own (self-interest) way of accounting and financial reporting for the related party transactions, co-borrowed debt, and receivable-payable offsets. From a justice perspective, the audit was biased towards the interests of the Rigas family. In treating equals, equally and unequals, unequally, the fact is the shareholders and creditors had a greater claim to accurate and reliable financial statements and their rights should have been stressed above all else. Using virtue theory, honesty requires that the statements should be truthful and fully disclose all relevant information on related parties’ transactions. The accounting and reporting of other transactions should be consistent with diligence, responsibility, and transparency. Impartiality requires that Deloitte should not be biased towards the Rigas family. Perhaps the auditors feared losing a major client and allowed client interests and pressures on the auditor to rule the day. This would be a stage 3 reasoning approach to moral decision-making.

**Questions**

1. **Dearlove and Deloitte had identified the audit as posing much greater risk than normal. Describe the audit risk factors in the case that most likely would have led to this conclusion.**

For several years, Deloitte had concluded that the Adelphia engagement posed a "much greater than normal" risk of fraud, misstatement, or error; this was the highest risk category that Deloitte recognized. Risk factors that Deloitte specifically identified in reaching this assessment for the 2000 audit included the following:

* Adelphia operated in a volatile industry, expanded rapidly, and had a large number of decentralized operating entities with a complex reporting structure;
* Adelphia carried substantial debt and was near the limit of its financial resources, making it critical that the company comply with debt covenants;
* Management of Adelphia was concentrated in a small group without compensating controls;
* Adelphia management lacked technical accounting expertise but nevertheless appeared willing to accept unusually high levels of risk, tended to interpret accounting standards aggressively, and was reluctant to record adjustments proposed by auditors; and
* Adelphia engaged in significant related party transactions with affiliated entities that Deloitte would not be auditing.

To help manage the audit risk, Deloitte planned, among other things, to increase Deloitte's management involvement at all stages of the audit and to heighten professional skepticism. One has to wonder Deloitte felt management’s involvement needed to be ratcheted up when it was management’s behavior that was being reviewed and an integral part of the overall assessment of the internal control environment.

Deloitte had specifically identified areas posing high risk including Adelphia’s rapid expansion, substantial debt load, and significant related party transactions. The high risk areas are demonstrated by three separate transactions: (1) Offsetting receivables and payables; (2) Reporting Co-borrowed debt; and (3) Direct placement of stock transactions.

1. **Classify each of the accounting issues in the case into the financial shenanigans identified by Schilit in Chapter 7. Are there any accounting procedures that do not fit into one of the shenanigans? If not, make up a category to describe such procedures in a general way as did Schilit. Comment on the earnings management effects as well.**

The Adelphia case has three accounting transactions not in compliance with GAAP. The offsetting receivables and payables is a form of shenanigan number 5, failing to record or improperly reducing liabilities. This failure to account for offsetting receivables and payable means that interest expense may be understated. The reporting of coborrowed debt is a form of shenanigan number 5, failing to record or improperly reducing liabilities. This failure to record coborrowed debt also indicates that interest expense may be understated.

A key issue in the case is the proper reporting of the co-borrowed debt and related party transactions. A review of the contingent liability rules seems to indicate that the disclosures were inadequate for a reasonably possible loss. It does not appear a liability should have been recorded based on a probable outcome. The co-borrowed debt and related party transactions could be put into an eighth shenanigan on disclosure fraud: failing to adequately disclose relevant details about contingent events and related-party transactions.

**Describe each of the auditing standards and procedures the auditors failed to adhere to given the facts of the case. How did the failure of the auditors to follow them violate Deloitte’s ethical standards as evidenced by the deficiencies in the work of Dearlove and other members of the audit engagement team?**

The accepted auditing standards require the auditors to plan the audit adequately and to properly supervise any assistants. Auditors must exercise due professional care in performing an audit and preparing a report. They must maintain an attitude of professional skepticism, which includes a questioning mind and a critical assessment of audit evidence. They must obtain sufficient competent evidential matter to afford a reasonable basis for an opinion with respect to the financial statements under review. Auditors are expected to develop procedures to identify fraud in the financial statements, especially those related to material misstatements.

Specifically, in the area of the offsetting or netting of receivables and payables, the SEC found no evidence in the audit workpapers that Deloitte gave any consideration to the propriety of Adelphia’s netting during the 2000 audit or that the audit team conducted any analysis of FASB Interpretation 39, Offsetting of Amounts Related to Certain Contracts (FIN 39), requirements. There is no evidence that Dearlove made any attempt to determine the gross amounts of Adelphia’s related party accounts payables and receivables. In this area the SEC found that Dearlove did not obtain sufficient competent evidential material to support his conclusion that Adelphia’s netting was properly done; he did not exercise appropriate skepticism despite circumstances requiring heightened scrutiny; and he did not properly supervise the audit team to ensure that significant related party transactions, like this netting, were afforded appropriate review. Sufficient audit evidence was lacking in some cases and the auditors allowed themselves to be influenced by client management on a number of issues. The ethical standards of integrity and objectivity, due care including professional skepticism, and following GAAP and GAAS were violated as evidenced by how the auditors went about gathering evidence on transactions and developing workpaper information.

In the area of co-borrowed debt, the SEC found that Deloitte and Dearlove created no workpapers documenting its examination of Adelphia’s decision. There is no evidence that Dearlove or the audit team conducted an analysis of Adelphia’s potential for liability under the credit agreements; nor is there evidence that Dearlove directed the audit team to conduct such an analysis. Instead, Dearlove’s conclusion was based on a series of assumptions about the Rigas Entities’ and the Rigas family’s willingness and ability to pay the co-borrowing Rigas Entities’ debt – assumptions that were either untested or inadequately tested. Each of Dearlove’s failures to meaningfully review Adelphia’s chances of suffering a loss on the co-borrowings resulted in a violation of the professional standards. The review of co-borrowed debt did not meet the GAAS to exercise due professional care and professional skepticism, adequately plan the audit, and obtain sufficient competent evidential matter to afford a reasonable basis for his opinion that Adelphia’s chances of incurring a loss were remote.

In the area of the adequacy of the note disclosure of Adelphia’s contingent liability, the SEC found that Dearlove and Deloitte failed to exercise the level of professional care called for by the high-risk account and failed to employ professional skepticism in analyzing the note disclosure, and failed to apply audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements.

These failures by Deloitte and Dearlove violate the ethical standards of independence (rule 101), objectivity and skepticism (rule 102), due care and competence (rule 201), compliance with auditing standards (rule 202), accounting principles (rule 203), and acts discreditable (rule 501).

**Optional Question**

1. **Do you believe that Deloitte violated its ethical and professional responsibilities in the audit of Adelphia by being liable for negligence, gross negligence, or fraud? Explain the reasons for your answer using the discussion in Chapter 6 for support.**

Negligence is a violation of a legal duty to exercise a degree of care that an ordinary prudent person would exercise under similar circumstances. For a CPA, negligence is failure to perform a duty in accordance with applicable standards; it may be viewed as failure to exercise due professional care. Gross negligence is the lack of even slight care, indicative of a reckless disregard for one’s professional responsibilities. Fraud is defined as misrepresentation by a person of a material fact known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured.

In the Adelphia case, Deloitte and Dearlove violated ethical and professional responsibilities and were liable for negligence. The audit was performed without exercise of due professional care and with reckless disregard for GAAS and proper financial reporting. Deloitte was found guilty of fraud in a case brought by the U.S. department of Justice and SEC. It does seem quite clear that fraud existed and Adelphi was a willing participant because it knew of the co-borrowed debt and contingent liability, improper reporting of related party transactions, and receivable-payable offset, but the firm did little to insist that proper accounting and financial reporting occurred in these instances.