**Major Case 1 Adelphia Communications Corporation**

On July 24, 2009, the U.S. Court of Appeals for the District of Columbia upheld the finding of the SEC that Gregory M. Dearlove, a certified public accountant and formerly a partner with the accounting firm Deloitte & Touche LLP, engaged in improper professional conduct within the meaning of Rule of Practice 102(e). Dearlove served as the engagement partner on Deloitte’s audit of the financial statements of Adelphia Communications Corporation, a public company, for the fiscal year ended December 31, 2000. The SEC confirmed its original ruling that Adelphia’s financial statements were not in accordance with generally accepted accounting principles, and that Dearlove violated generally accepted auditing standards. The administrative law judge (ALJ) also found that Dearlove was a cause of Adelphia’s violations of the reporting and record-keeping provisions of the Exchange Act. The ALJ permanently denied Dearlove the privilege of appearing or practicing in any capacity before the commission.

The opinion for the court was filed by Judge Douglas H. Ginsburg of the U.S. Court of Appeals for the D.C. Circuit Court. The opinion states that the SEC concluded that Dearlove engaged repeatedly in unreasonable conduct resulting in violations of applicable accounting principles and standards while serving as Deloitte’s engagement partner in charge of the 2000 audit of Adelphia. Dearlove had argued that the SEC committed an error of law, misapplied the applicable accounting principles and standards, and denied him due process. Because the SEC made no error of law, and substantial evidence supports its findings of fact, the court denied the petition.

***Background Issues***

John Rigas had founded Adelphia, the Greek word for brothers, in 1952, and Rigas and his children were the controlling shareholders in 2000. By the year 2000, Adelphia was one of the largest cable television companies in the United States. It had doubled the number of cable subscribers that it served by acquiring several other cable companies in late 1999. Although its assets were growing, Adelphia’s debt grew substantially as well. The SEC found that, prior to 2000, Adelphia, its subsidiaries, and some Rigas-affiliated entities entered as coborrowers into a series of credit agreements. By 1999, Adelphia and the entities had obtained $1.05 billion in credit; in 2000, they tripled their available credit and drew down essentially all the funds available under the agreements.

Deloitte audited Adelphia’s financial statements from 1980 through 2002, with Dearlove as the engagement partner. Dearlove and the Deloitte team described the 2000 audit, like many prior audits of Adelphia, as posing “much greater than normal risk” because Adelphia engaged in numerous transactions with subsidiaries and affiliated entities, many of which were owned by members of the Rigas family.

Deloitte issued its year 2000 independent auditor’s report of Adelphia—signed by Dearlove—on March 29, 2001. In January 2002, in the wake of the Enron scandal, the SEC released a statement regarding the disclosure of related-party transactions. In March, Adelphia disclosed its obligations as co-debtor with the Rigas entities. Its share price declined from $30 in January 2002 to $0.30 in June, when it was delisted by the National Association of Securities Dealers (NASDAQ). In September 2002, the U.S. Department of Justice (DOJ) brought criminal fraud charges against Adelphia officials, including members of the Rigas family, and Adelphia agreed to pay $715 million into a victims’ restitution fund as part of a settlement with the government. In April 2005 the SEC brought and settled civil actions against Adelphia, members of the Rigas family, and Deloitte.

***SEC Charges***

In September 2005, the SEC charged Dearlove with improper conduct resulting in a violation of applicable professional standards, including his approval of Adelphia’s method of accounting for transactions between itself and one or more Rigas entities (i.e., related-party transactions). The matter was referred to the ALJ, who presided at an administrative trial-type hearing to resolve the dispute between the SEC and Adelphia. The ALJ determined Dearlove had engaged in one instance of “highly unreasonable” conduct and repeated instances of “unreasonable” conduct, and permanently denied Dearlove the right to practice before the SEC. Upon review of the ALJ’s decision, the SEC held Dearlove had engaged in repeated instances of unreasonable conduct as defined under Rule 102 and denied him the right to practice before the SEC, but provided him the opportunity to apply for reinstatement after four years. Dearlove petitioned for review of that decision, which was denied by the U.S. Court of Appeals.

SEC Rule 102(e) provides the SEC may “deny, temporarily or permanently, the privilege of appearing or practicing before [the SEC] in any way to any person who is found by the Commission . . . to have engaged in unethical or improper professional conduct.” The rule defines three classes of “improper professional conduct” for accountants: (1) “Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards,” (2) “a single instance of highly unreasonable conduct that results in a violation of applicable professional standards,” and (3) “repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.” The court supported the SEC’s determination that Dearlove repeatedly engaged in unreasonable conduct.

While most of the alleged fraud at Adelphia took its form in hidden debt, the trial was also notable for examples of the eye-popping personal luxury that has marked other white-collar trials such as at Tyco.

In the court case, prosecutor Christopher Clark led off his closing argument by saying John Rigas had ordered two Christmas trees flown to New York, at a cost of $6,000, for his daughter. Rigas also ordered up 17 company cars and the company purchase of 3,600 acres of timberland at a cost of $26 million to preserve the pristine view outside his Coudersport, Pennsylvania, home. Timothy Rigas, the CFO, had become so concerned that he limited his father to withdrawals of $1 million per month.

***Deloitte’s Audit***

Deloitte served as the independent auditor for Adelphia, one of its largest audit clients, from 1980 through 2002. The audits were complex. Several of Adelphia’s subsidiaries filed their own Form 10-K annual reports with the SEC. 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.
* 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 “to ensure that the appropriate work is planned and its performance is properly supervised.” It also proposed to heighten professional skepticism “to ensure that accounting estimates, related-party transactions, and transactions in the normal course of business appear reasonable and are appropriately identified and disclosed.”

On March 29, 2001, Deloitte issued its independent auditor’s report, signed by Dearlove, which stated that it had conducted its audit in accordance with GAAS and that such audit provided a reasonable basis for its opinion that Adelphia’s 2000 financial statements fairly presented Adelphia’s financial position in conformity with GAAP.

***Charges against Rigas Family and Deloitte***

In the wake of Adelphia’s decline, the DOJ brought criminal fraud charges against several members of the Rigas family and other Adelphia officials. The DOJ declined to file criminal charges against Adelphia as part of a settlement in which Adelphia agreed to pay $715 million in stock and cash to a victims’ restitution fund once the company emerged from bankruptcy.

The SEC brought several actions related to the decline of Adelphia. On April 25, 2005, Adelphia, John Rigas, and Rigas’s three sons settled a civil injunctive action in which the respondents, without admitting or denying the allegations against them, were enjoined from committing or causing further violations of the anti-fraud, reporting, record-keeping, and internal controls provisions of the federal securities laws. The next day, the commission instituted and settled administrative proceedings against Deloitte under Rule 102(e). Without admitting or denying the commission’s allegations, Deloitte consented to the entry of findings that it engaged in repeated instances of unreasonable conduct with respect to the audit of Adelphia’s 2000 financial statements. Deloitte also consented to a finding that it caused Adelphia’s violations of those provisions of the Securities and Exchange Act that require issuers to file annual reports, make and keep accurate books and records, and devise and maintain a system of sufficient internal controls. Deloitte agreed to pay a $25 million penalty and to implement various prophylactic policies and procedures. The commission also settled a civil action, based on the same conduct, in which Deloitte agreed to pay another $25 million penalty. Senior manager William Caswell consented to commission findings that he committed repeated instances of unreasonable conduct and agreed to a bar from appearing or practicing as an accountant before the commission with a right to apply for reinstatement after two years.

***Violation of GAAS: General, Fieldwork, and Reporting Standards***

In determining whether to discipline an accountant under Rule 102(e)(1)(iv), the commission has consistently measured auditors’ conduct by their adherence to or deviation from GAAS. Certain audit conditions require auditors to increase their professional care and skepticism, as when the audit presents a risk of material misstatement or fraud. When an audit includes review of related-party transactions, auditors must tailor their examinations to obtain satisfaction concerning the purpose, nature, and extent of those transactions on the financial statements. Unless and until an auditor obtains an understanding of the business purpose of material related-party transactions, the audit is not complete. These standards can overlap somewhat, and one GAAS failure may contribute to another.

Dearlove asked the court to compare the reasonableness of his conduct to a standard used by New York state courts in professional negligence cases, that the standard for determining negligence by an accountant should be based on whether the respondent “use[d] the same degree of skill and care that other [accountants] in the community would reasonably use in the same situation.” Dearlove believed that his actions should be judged in the context of the large, complex Adelphia audit and to determine whether he exercised the degree of skill and care, including professional skepticism, that a reasonable engagement partner would have used in similar circumstances. Dearlove contended that this analysis “necessarily includes . . . conclusions previously reached by other professionals,” a reference to the Adelphia audits that Deloitte conducted from 1994 through 1999. Dearlove asserted that he could place some reliance on audit precedent. Moreover, in his view, the fact that prior auditors reached the same conclusions was “compelling evidence” that Dearlove acted reasonably. The court rejected any suggestion that the conduct of prior auditors should be a substitute for the standards established by GAAS, ruling that “these standards apply to audits of all sizes and all levels of complexity and describe the conduct that the accounting profession itself has established as reasonable, provid[ing] a measure of audit quality and the objectives to be achieved in an audit.” The court, therefore, declined to create a separate standard of professional conduct for auditors that depends in each case on the behavior of a particular auditor’s predecessors.

The SEC found that prior Deloitte audits offered little support for the conclusions reached in the 2000 audit. The record did not describe how the audits of prior financial statements were performed or what evidential matter supported those audit conclusions. Moreover, Dearlove’s expert, while arguing that partner rotation does not require the new auditor to perform a “de novo audit of the client,” nevertheless explained that an engagement partner “would perform . . . new audit procedures or GAAP research and consultation . . . to address changed conditions or professional standards.” In 2000, Dearlove was presented with markedly different circumstances from those presented to prior teams: Since 1999, Adelphia had tripled its coborrowed debt, doubled its revenues and operating expenses, and acquired more cable subscribers. The changes implicated areas of the Adelphia audit that Deloitte had specifically identified as posing high risk—namely, its rapid expansion, substantial debt load, and significant related-party transactions. Therefore, the court rejected Dearlove’s argument that the similarity of prior audit conclusions lent reasonableness to his own audit and found no reason to reject GAAS as the standard by which we judge all audits.

***Violation of Accounting and Reporting Standards***

Having determined that Dearlove’s conduct was unreasonable, the SEC turned to the applicable professional accounting and reporting standards. The GAAS required that when an audit posed greater than normal risk—as Dearlove had determined the Adelphia audit did—there must be “more extensive supervision by the auditor with final responsibility for the engagement during both the planning and conduct of the engagement.” The SEC found no evidence in the audit workpapers or elsewhere in the record that Dearlove gave any consideration to the propriety of at least three separate transactions: (1) offsetting of receivables and payables, (2) reporting of coborrowed debt, and (3) direct placement of stock transactions.

**Offsetting Receivables and Payables**

Accounting Principles Board Opinion No. 10 states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” Rule 5-02 of the commission’s Regulation S-X requires that issuers “state separately” amounts payable and receivable. Interpretation 39, Offsetting of Amounts Related to Certain Contracts, defines a right of setoff as “a debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt of another party by applying against the debt an amount that the other party owes to the debtor. The Interpretation is consistent with Rule 5-02.

The court had concluded that Adelphia’s presentation of a net figure for its related-party payables and receivables violated GAAP. Because Adelphia netted the accounts payable and receivable of its various subsidiaries against the accounts payable and receivable of various Rigas entities on a global basis, it did not comport with Interpretation 39’s basic requirement that netting is appropriate only when two unrelated parties are involved.

The SEC held Adelphia violated GAAP because its netting involved more than two parties: “Adelphia netted the accounts payable and receivable of its various subsidiaries against the accounts payable and receivable of various Rigas Entities on a global basis . . . [and] netting is appropriate only when two parties are involved.”

The SEC analyzed the record and determined that Dearlove’s conduct was unreasonable in the circumstances and that it resulted in a violation of professional standards—both GAAS and GAAP. Because GAAS focuses upon an auditor’s performance and requires him to exercise due professional care, the commission rejected Dearlove’s attempt to fault the SEC for marshaling the same evidence to show that his conduct was unreasonable and that he failed to exercise due professional care in performing the audit.

**Coborrowed Debt**

Between 1996 and 2000, several Adelphia subsidiaries and some of the Rigas entities had entered as coborrowers into a series of three credit agreements with a consortium of banks. Although the agreements differed in the amount of credit available, their terms were substantially the same: each borrower provided collateral for the loan; each could draw funds under the loan agreement; and each was jointly and severally liable for the entire amount of funds drawn down under the agreement, regardless of which entity drew down the amount. By year-end 2000, the total amount of coborrowed funds drawn under the credit agreements was $3.751 billion, more than triple the $1.025 billion borrowed at year-end 1999. Of this amount, Adelphia subsidiaries had drawn approximately $2.1 billion, and Rigas entities had drawn $1.6 billion.

Generally, an issuer must accrue on its balance sheet a debt for which it is the primary obligor. However, when an issuer deems itself to be merely contingently liable for a debt, *Statement of Financial Accounting Standards (SFAS) 5* provides the appropriate accounting and reporting treatment for that liability. *SFAS 5* establishes a three-tiered system for determining the appropriate accounting treatment of a contingent liability, based on the likelihood that the issuer will suffer a loss—that is, be required to pay the debt for which it is contingently liable. If a loss is *probable* (i.e., likely) and its amount can be reasonably estimated, the liability should be accrued on the issuer’s financial statements as if the issuer were the primary obligor for the debt. If the likelihood of loss is only *reasonably possible* (defined as more than remote but less than likely), or if the loss is probable but not estimable, the issuer need not accrue the loss but should disclose the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. The issuer still must disclose the “nature and amount” of the liability, even if the likelihood of loss is only *remote* (slight). From 1997 through 1999, Adelphia had included in the liabilities recorded on its balance sheet the amount that its own subsidiaries had borrowed, but it did not consider itself the primary obligor for the amount that the Rigas entities had borrowed and therefore did not include that amount on its balance sheet. Instead, Adelphia accounted for the amounts borrowed by the Rigas entities by making the following disclosure in the footnotes to its financial statements:

Certain subsidiaries of Adelphia are coborrowers with Managed Partnerships (i.e., Rigas entities) under credit facilities for borrowings of up to [the total amount of all coborrowed debt available to Adelphia and the Rigas entities that year]. Each of the coborrowers is liable for all borrowings under this credit agreement, although the lenders have no recourse against Adelphia other than against Adelphia’s interest in such subsidiaries.

Deloitte had approved this treatment in the audits it conducted from 1997 to 1999.

Dearlove knew that Adelphia considered the Rigas entities’s debt to be a contingent liability for which its chances of suffering a loss were merely remote, making accrual on the balance sheet unnecessary pursuant to *SFAS 5.* Deloitte created no workpapers documenting its examination of Adelphia’s decision. However, from the record, it appears that Deloitte considered the matter and focused its review on the likelihood, as defined by *SFAS 5,* that Adelphia would have to pay Rigas entities’s share of coborrowed debt.

Dearlove also believed that, although the Rigas family was not legally obligated to contribute funds in the event of a default by the coborrowers, the family would be economically compelled to protect their Adelphia holdings by stepping in to prevent a default by the entities. Dearlove did not, however, conduct any inquiry into whether the family would, in fact, use their personal assets to prevent a default by Adelphia. Dearlove estimated the value of the Rigas family’s holdings of Adelphia stock by multiplying the number of shares the Rigases owned by the price per Class A share, resulting in a figure of approximately $2.3 billion, which he concluded was by itself ample to cover the debt and conclude his *SFAS 5* analysis. However, Dearlove did not determine if these Rigas family assets were already encumbered by other debt; he saw no financial statements or other proof of the family’s financial condition other than local media reports that the Rigases “were billionaires.” Dearlove testified that he “never asked them: Are you worth $2 billion, $3 billion, or $10 billion?” Dearlove also did not consider whether disposing of some or all of the family’s stock in Adelphia might result in a downward spiral in the stock’s value or in a change in their control of the company, in the event of a default by the entities under the coborrowing agreements.

Dearlove testified that, at the end of the 2000 audit, he spoke to senior manager Caswell for about 15 minutes regarding the requirements of *SFAS 5.* During this meeting, they concluded that “the assets of the cable systems and the Adelphia common stock that the Rigases owned exceeded the amount of debt that was on the coborrowed entities, and the overhang . . . exceeded the coborrowing by hundreds of millions if not billions of dollars.” Dearlove testified that, although other assets could have been included in an *SFAS 5* analysis, these two assets alone were sufficient to allow the auditors to conclude that Adelphia’s contingent liability was remote. Deloitte therefore approved Adelphia’s decision to exclude Rigas entities’s $1.6 billion in coborrowed debt from its balance sheet and to instead disclose the debt in a footnote to the financial statements.

When it reviewed the adequacy of the note disclosure that Adelphia planned to use (which was identical to the language it had used in previous years), the audit team initially believed the disclosure should be revised. During the 2000 quarterly reviews, audit manager Ivan Hofmann and others had repeatedly encouraged Adelphia management to disclose the specific dollar amount of Rigas entities’ coborrowings, but Adelphia continually ignored Deloitte’s suggestions. Although Deloitte was unaware of it at the time, Adelphia management was working purposefully to obfuscate the disclosure of Rigas entities’s coborrowed debt.

In November 2000, at a third-quarter wrap-up meeting attended by Dearlove, Caswell, and Hofmann, Adelphia management (including Adelphia’s vice president of finance, James Brown) agreed to make disclosures regarding the amounts borrowed by the Rigas entities under the coborrowing agreements. Caswell and Hofmann subsequently suggested improvements to the note disclosure in written comments on at least six drafts of the 10-K; they proposed adding language that would distinguish the amount of borrowings by Adelphia subsidiaries and Rigas entities, such as the following: “A total of $—— related to such credit agreements is included in the company’s consolidated balance sheet at December 31, 2000. The [Rigas] entities have outstanding borrowings of $—— as of December 31, 2000, under such facilities.”

At the end of March 2001, as Deloitte was concluding its audit of the 2000 financials, Brown—despite his agreement in November 2000 to disclose the amount of Rigas entities’s borrowing—informed the audit team that he did not think that the additional disclosure was necessary. Instead, Brown proposed adding a phrase explaining that each of the coborrowers “may borrow up to the entire amount available under the credit facility.” Brown argued that his proposed language was more accurate than Deloitte’s proposal because the lines of credit could fluctuate and, as a result, it would be better to disclose Adelphia’s maximum possible exposure. Caswell agreed to take Brown’s language back to the engagement team, but he told Brown that he did not agree with Brown and did not think that Deloitte would accept his proposed language.

Notwithstanding Caswell’s reaction, Brown soon afterward presented his proposed language to the audit team, including Dearlove, Caswell, and Hofmann, during the audit exit meeting on March 30, 2001. Brown claimed that his proposed disclosure language had been discussed with, and approved by, Adelphia’s outside counsel. Although Dearlove characterized the disclosure issue as “really one of the more minor points that [the audit team was] trying to reconcile at that point,” the ALJ did not accept this testimony. Dearlove testified that he was “concerned” about “making it clear to the reader how much Adelphia could be guaranteeing,” and that Brown’s language was “more conservative” but “wasn’t necessarily what we were attempting to help clarify.” Dearlove also testified that he told Brown, “I don’t understand how that [proposed change] enhances the note” but that, after “an exchange back and forth relative to that,” Dearlove “couldn’t persuade him as to what he wanted.” Nevertheless, Dearlove told Brown that he agreed with the proposal and approved the change. Caswell and Hofmann also indicated their agreement.

Adelphia’s note disclosure of the coborrowed debt, as it appeared in its 2000 Form 10-K with Brown’s added language, read as follows:

Certain subsidiaries of Adelphia are coborrowers with Managed Entities under credit facilities for borrowings of up to $3,751,250,000. Each of the coborrowers is liable for all borrowings under the credit agreements, and may borrow up to the entire amount of the available credit under the facility. The lenders have no recourse against Adelphia other than against Adelphia’s interest in such subsidiaries.

***Adequacy of the Note Disclosure of Adelphia’s Contingent Liability***

The SEC also considered whether Adelphia’s footnote disclosure of Rigas entities’ coborrowings was appropriate under GAAP. Adelphia disclosed the total amount of credit available to the coborrowers (“up to” $3.75 billion) without indicating whether any portion of that available credit had actually been drawn down, much less that all of it had. This disclosure was inadequate to inform the investing public that Adelphia was already primarily liable for $2.1 billion and a guarantor for the remaining $1.6 billion that had been borrowed by Rigas entities. Therefore, it did not comply with the requirement in *SFAS 5* to disclose the amount of the contingent liability.

The SEC concluded that Dearlove acted unreasonably in his audit of Adelphia’s note disclosure, resulting in several violations of GAAS. In high-risk audit environments such as that presented by the Adelphia engagement, GAAS specifically recommend “increased recognition of the need to corroborate management explanations or representations concerning material matters—such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity” when audit risk increases. The accounting for Adelphia’s coborrowed debt implicated the extensive related-party transactions and high debt load that were part of the basis for Deloitte’s high-risk assessment for the Adelphia audit. Management’s insistence on its own accounting interpretation was precisely the behavior identified by the audit plan as presenting a much higher than normal risk of misstatement in the audit.

Moreover, Dearlove knew that the audit team believed that the footnote disclosure in previous years was inadequate and had urged additional disclosure that would have made clear the extent of Rigas entities’s actual borrowings and Adelphia’s resulting potential liability. Dearlove did not think that Brown’s language helped achieve Deloitte’s goal of clarifying the extent of Rigas entities’s debt and Adelphia’s obligation as guarantor. Yet Dearlove accepted Brown’s language without probing his reasons for the change, without understanding Adelphia’s reasons for rejecting Deloitte’s language, and without discussing the issue with the concurring or risk review partners assigned to the audit. This unquestioning acceptance of Brown’s proposed disclosure language was a clear—and at least unreasonable—departure from the requirements of GAAS to apply greater than normal skepticism and additional audit procedures in order to corroborate management representations in a high-risk environment. Dearlove’s conduct resulted in violations of applicable professional standards.

Dearlove asserted that disclosure of the amount that Rigas entities could theoretically borrow (up to $3.75 billion) was more conservative than disclosure of the $1.6 billion that it had actually borrowed. The SEC concluded that the footnote disclosure was materially misleading to investors: “Materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.” If “there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision,” the information is material. A reasonable investor would think it significant that the footnote disclosure spoke only in terms of potential debt when, in fact, the entire line of credit had been borrowed and $1.6 billion of it was excluded from Adelphia’s balance sheet but potentially payable by Adelphia. It was especially important for this information to appear in Adelphia’s financial statements because investors had no access to the financial statements of the privately held Rigas entities. The SEC rejected Dearlove’s argument that Adelphia’s note complied with *SFAS 5*’s requirement to disclose the amount of debt that Adelphia guaranteed.

***Debt Reclassification***

After the end of the second, third, and fourth quarters of 2000, Adelphia’s accounting department transferred the reporting of approximately $296 million of debt from the books of Adelphia’s subsidiaries to the books of various Rigas entities. In exchange, Adelphia eliminated from its books receivables owed to it by the respective Rigas entities in the amount of debt transferred. The three transfers were in the amounts of $36 million, approximately $222 million, and more than $38 million, respectively. In each instance, the transaction took place after the end of the quarter, and each transfer involved a post-closing journal entry that was retroactive to the last day of the quarter.

A checklist prepared by Deloitte in anticipation of the 2000 audit showed that Deloitte was aware of a significant number of related-party transactions that had arisen outside the normal course of business and that past audits had indicated a significant number of misstatements or correcting entries made by Adelphia, particularly at or near year-end. An audit overview memorandum recognized as a risk area that “Adelphia records numerous post-closing adjusting journal entries” and provided as an audit response, “[Deloitte] engagement team to review post-closing journal entries recorded and review with appropriate personnel. Conclude as to reasonableness of entries posted.” An audit planning memorandum provided that “professional skepticism will be heightened to ensure that . . . related party transactions . . . are appropriately identified and disclosed” and that auditors should “increase professional skepticism in [areas] where significant related party transactions could occur.”

Dearlove testified that Deloitte had identified the Rigas family’s control of both Adelphia and Rigas entities as posing a special risk. Dearlove also testified that he believed that it was important to know whose debt was whose, concerning Adelphia and Rigas entities. He testified that he was “generally aware the debt was audited,” but that he did not review the debt workpapers directly. He also testified: “I don’t recall [debt] being [a] particularly sensitive area, . . . I don’t recall issues raised to me of difficulties we had. I don’t recall any particular conversation I had with the team” concerning the audit of the debt. The record does not show that Dearlove knew of the three journal entries involving debt reclassification at the time of the audit.

*Statement of Financial Accounting Standards (SFAS) 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities,* permits a debtor to derecognize a liability “if and only if it has been extinguished.” *SFAS 125* provides that a liability is extinguished if either (1) the debtor pays the creditor and is relieved of its obligation for the liability, or (2) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

When the Adelphia subsidiaries posted the debt in question to their books, they acknowledged their primary liability for the amounts posted. They could not remove the debt properly from their books without first satisfying the requirements of *SFAS 125* that either the Adelphia subsidiaries repaid the debt to the creditor during the relevant reporting periods or a creditor had released the subsidiaries from their liability for repayment. The evidence does not show, and Dearlove did not contend, that either of these events occurred. Adelphia’s attempt to extinguish the debt unilaterally merely by shifting the reporting to Rigas entities violated GAAP and rendered its financial statements materially misleading by making Adelphia’s debt appear less than it was.

Dearlove did not dispute that “certain debt which had been posted to Adelphia was later posted to a Rigas entity.” However, focusing on the statement in the initial decision that “once Adelphia’s subsidiaries had posted this debt to their books they became primary obligors for the amounts posted,” Dearlove argued that *SFAS 125* does not define the circumstances under which an entity recognizes debt that may be derecognized only under the *SFAS 125* criteria. He claimed that the initial decision of the commission improperly “assumed without analysis” that the posting of debt in a ledger is such a circumstance. Dearlove argued that the application of *SFAS 125* is complex where entities are jointly and severally liable for an obligation, and it did not apply where an entity is secondarily or contingently rather than primarily liable. He asserted that Adelphia was arguably not required to recognize debt in cases where co-borrowed funds were intended to be used by other co-borrowers. He stopped short, however, of saying that the funds at issue were so intended, and our review of the record yields nothing to support such a contention. The record did not establish that all the reclassified debt was c-borrowed debt, and the ALJ correctly concluded that the impropriety of Adelphia’s debt reclassification was unaffected by the question whether the debt was co-borrowed. In addition, Dearlove cited no authority to support his contention that *SFAS 125* is applicable only where primary obligors were required to recognize a liability, and we are aware of none.

The crucial question for the *SFAS 125* analysis is whether the debt was extinguished in one of the enumerated ways. If the debt was not extinguished as provided in *SFAS 125,* the debtor may not derecognize it. The SEC found that the debts were recognized when booked and that, because there was no evidence that the debts were extinguished under *SFAS 125,* the accounting treatment violated GAAP.

With respect to the direct placement of stock transactions, on at least four occasions corresponding with public offerings by Adelphia, Adelphia removed a portion of Co-Borrowing Credit Facility Debt from its books as part of sham transactions in which a Rigas Entity non-co-borrower received Adelphia securities and a Rigas Entity co-borrower "assumed" debt of Adelphia. In each instance, Adelphia claimed in Commission filings and other public statements that Adelphia had applied some or all of the proceeds from these securities transactions actually to pay down debt, when — in fact — these transactions were shams with no bona fide proceeds, and resulted only in the transfer of Adelphia's debt to the books of Rigas Entity co-borrowers.

The commission also found that Dearlove’s conduct in his audit of Adelphia’s accounting for debt was at least unreasonable, resulting in several GAAS violations. As explained, Dearlove knew that Adelphia had a large number of decentralized operating entities with a complex reporting structure, carried substantial debt, and engaged in significant related-party transactions with affiliated entities that Deloitte would not be auditing. He also knew that Adelphia management tended to interpret accounting standards aggressively. Moreover, the audit plan specifically required that post-closing journal entries be examined in particular detail and that the audit team draw conclusions as to their reasonableness. Dearlove knew that these factors, together with others, led Deloitte to identify the Adelphia audit as posing a “much greater than normal” risk of fraud, misstatement, or error. In addition, Dearlove knew that Adelphia management netted its affiliate accounts payable and receivable and sought to reduce the amount of related-party receivables that it reported.

In this context, GAAS required Dearlove to consider the “much greater than normal” risk of the audit in determining the extent of procedures, assigning staff, and requiring appropriate levels of supervision. In addition, he was required to “direct the efforts of assistants who [were] involved in accomplishing the objectives of the audit and [to] determin[e] whether those objectives were accomplished.” He was required to exercise “an attitude that includes a questioning mind and a critical assessment of audit evidence,” “to obtain sufficient competent evidential matter to provide . . . a reasonable basis for forming a conclusion,” and, after identifying related-party transactions, to “apply the procedures he consider[ed] necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements.”

The reclassified debt involved post-closing journal entries of a magnitude significant enough to require the auditors to confront management and request an explanation, as required by Deloitte’s audit planning documents. After discussing the entries with appropriate Adelphia personnel, Deloitte should have documented management’s explanation and Deloitte’s conclusions as to whether the accounting treatment was reasonable in the audit workpapers. The record did not show that any of these steps was taken. The failure to take them was, at the very least, unreasonable.

The SEC concluded that Dearlove had acted at least unreasonably in signing an unqualified audit opinion (i.e., unmodified) stating that Deloitte had conducted its audit in accordance with GAAS and that such audit provided a reasonable basis for its opinion that Adelphia’s 2000 financial statements fairly presented Adelphia’s financial position in conformity with GAAP.

***Postscript***

On April 21, 2005, it was announced that Time Warner and Comcast were buying bankrupt cable company Adelphia Communications in a $17.6 billion cash-and-stock deal. As a result of a settlement of actions against Adelphia and members of the Rigas family for securities fraud and other violations, and a related criminal forfeiture action, the U.S. Department of Justice and the U.S. Securities and Exchange Commission obtained a recovery consisting of cash of approximately $729 million. The funds were distributed to eligible claimants who suffered a financial loss as a direct result of the circumstances surrounding the Adelphia fraud.

Deloitte did not fare well in the investor lawsuits. On April 5, 2010, Deloitte & Touche LLP agreed to pay up to $210 million as part of a larger $455 million amount. Also, a number of banks, including Bank of America, Citigroup, JPMorgan Chase, Wachovia, and 35 others, agreed to pay to settle an investor lawsuit. Earlier, in 2005, Deloitte had paid the SEC $50 million to settle claims that it had incorrectly audited Adelphia’s 2000 financials. Not surprisingly, the defendants, Deloitte and the banks, admitted no wrongdoing, but Deloitte spokesperson Deborah Harrington said, “Deloitte & Touche believes it has no liability for the fraud by Adelphia and its former management. Deloitte & Touche also believes, however, that it was in the best interests of the firm and its clients to settle this action rather than to continue to face the expense and uncertainty of protracted litigation.”

As usual, the lawyers made out well in this case, landing a 21 percent share of the settlement (or about $94 million).

**This is a good case to have students review the SEC complaint against Deloitte and expand the scope of the case to enhance its usage as an end-of-course project. Here is the link to the complaint:** [**https://www.sec.gov/litigation/complaints/complr17627.htm**](https://www.sec.gov/litigation/complaints/complr17627.htm)**.**

**Instructors may want to add a fifth question if Chapter 6 is assigned in the course.**

**Optional Question**

**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.**

**Case Questions**

1. **Dearlove and Deloitte had identified the audit as posing much greater risk than normal. Describe the 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 why 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**](file:///F:\IM%204th%20ed%20FINAL\chapter07\reader_01.html)**. 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 payables means that interest expense may be understated. The reporting of co-borrowed debt is a form of shenanigan number 5, failing to record or improperly reducing liabilities. This failure to record co-borrowed debt also indicates that interest expense may be understated. Adelphia also failed to adequately disclose relevant information about these arrangements in a note especially given the agreement with Deloitte. Instead, it watered down the disclosure and made it more innocuous. Little is said in the case about the problems with the direct placement of stock transactions and it seems this may be more of an operational rather than financial “shenanigan.” The transactions were classified by the SEC as “sham” transactions. A review of the SEC complaint in the case indicates the following.

On at least four occasions corresponding with public offerings by Adelphia, Adelphia removed a portion of Co-Borrowing Credit Facility Debt from its books as part of sham transactions in which a Rigas Entity non-co-borrower received Adelphia securities and a Rigas Entity co-borrower "assumed" debt of Adelphia. In each instance, Adelphia claimed in Commission filings and other public statements that Adelphia had applied some or all of the proceeds from these securities transactions actually to pay down debt, when, in fact, these transactions were shams with no bona fide proceeds, and resulted only in the transfer of Adelphia's debt to the books of Rigas Entity co-borrowers.

Schilit’s shenanigans do not expressly address failed note disclosures although they emanate from the improper accounting. Perhaps an eighth shenanigan on “failure to properly disclose notes related to material transactions” would better capture those kinds of shenanigans. This is important because earnings management techniques come in all forms and sizes and failed note disclosures can mask income smoothing and other methods of earnings management. However, most of Adelphia’s shenanigans were motivated by the desire to mask related party transactions and the extent of debt due by Adelphia to creditors.

A key issue in the case is the proper reporting of the coborrowed 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 coborrowed 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.

1. **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 generally 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 year 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 coborrowed 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 coborrowing 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 coborrowings resulted in a violation of the professional standards. The review of coborrowed 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; 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 violated ethical standards. As cited in the SEC complaint these standards (and pre-revised AICPA Code rule numbers) include the following: 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).

1. **Analyze the actions of Deloitte and Dearlove from an ethical reasoning perspective.**

Reviewing the professional/ethical standards, Deloitte and Dearlove: had a duty and obligation of due care in conducting the audit; to approach the audit with a healthy dose 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.

**Instructors may want to add a fourth question if Chapter 6 is assigned in the course.**

**Optional Question**

**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 the 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.