

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 51606 / April 26, 2005**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 2237 / April 26, 2005**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-11910**

**In the Matter of**

**DELOITTE & TOUCHE LLP**

**Respondent**

**ORDER INSTITUTING PUBLIC  
ADMINISTRATIVE PROCEEDINGS  
PURSUANT TO RULE 102(e) OF THE  
COMMISSION'S RULES OF PRACTICE,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(1)(ii)<sup>1</sup> of the Commission's Rules of Practice against Deloitte & Touche LLP ("Deloitte").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer") that the Commission has determined to accept.<sup>2</sup> Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as

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<sup>1</sup> Rule 102(e)(1) provides, in pertinent part, that:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . (ii) . . . to have engaged in . . . improper professional conduct.

<sup>2</sup> Simultaneously with this proceeding the Commission has filed a settled action *SEC v. Deloitte & Touche LLP*, 05 Civ 4119 (S.D.N.Y), in which Deloitte consented to the entry of a judgment by the United States District Court for the Southern District of New York, pursuant to Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act"), ordering Deloitte to pay a \$25 million civil penalty.

to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>3</sup> that:

#### A. RESPONDENT AND OTHER RELEVANT ENTITIES

Deloitte & Touche LLP is a Delaware limited liability partnership that is headquartered in New York City. As of October 22, 2003, Deloitte was registered with the Public Company Accounting Oversight Board, pursuant to Section 102 of the Sarbanes Oxley Act of 2002, to prepare and issue audit reports on U.S. public companies. Deloitte served as the independent auditor for Adelphia Communications Corporation ("Adelphia") from at least 1986, the year when Adelphia's securities became publicly traded, until May 14, 2002, when Deloitte suspended its work on the audit for the year-ended December 31, 2001, citing, among other concerns, that Adelphia's books and records had been falsified. Starting in 1993, and until the audit was suspended in 2002, Deloitte serviced the Adelphia account through its Pittsburgh, Pennsylvania office (the "Pittsburgh Office"). Adelphia was one of the Pittsburgh Office's largest clients. In addition, Adelphia was deemed by the Pittsburgh Office to have "much greater than normal audit risk." Deloitte's engagement team included a Lead Client Service Partner (the "Engagement Partner"), a concurring review partner (the "Concurring Partner") and a Special Review Partner.

Adelphia Communications Corporation, a Delaware corporation that was headquartered in Coudersport, Pennsylvania, is the sixth largest cable television operator in the United States and, through numerous consolidated subsidiaries, provides cable television and local telephone service to customers in twenty-nine states and Puerto Rico. Prior to June 3, 2002, Adelphia's Class A shares were listed on the NASDAQ's National Market, while the Company's Class B shares were never publicly traded. Citing public interest concerns and Adelphia's failure to comply with NASDAQ Rule 431(c)(14), which requires an issuer, among other things, to timely file its Form 10-K, a NASDAQ Listing Qualifications Panel de-listed Adelphia stock, effective June 3, 2002. Adelphia shares are now quoted by Pink Sheets, LLC. On July 24, 2002, the Commission filed *SEC v. Adelphia Communications Corporation, et al.*, 02 Civ. 5776 (S.D.N.Y.) (PKC) ("*SEC v. Adelphia*"), alleging that Adelphia and six senior officers, including four members of the Rigas family, had engaged, between at least 1998 and March 2002, in widespread financial fraud and reporting violations. That action is pending. Since June 25, 2002, Adelphia and its subsidiaries have operated under the protection of Chapter 11 of the U.S. Bankruptcy Code.

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<sup>3</sup> The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

The Rigases include John Rigas (J. Rigas), his sons, Timothy J. Rigas (“T. Rigas”), Michael J. Rigas (“M. Rigas”) and James P. Rigas (“J.P. Rigas”), his daughter, Ellen Rigas Venetis (“E. Rigas”) and his spouse, Doris Nielsen Rigas (“D. Rigas”). At all relevant times, J. Rigas and members of his immediate family held five of Adelphia’s nine Board of Directors positions, and exercised voting control of Adelphia stock. Specifically, J. Rigas was Adelphia’s Chief Executive Officer and Chairman of its Board of Directors. T. Rigas, M. Rigas, and J.P. Rigas each were directors of Adelphia and held the positions, respectively, of Chief Financial and Accounting Officer, Executive Vice President for Operations, and Executive Vice President for Strategic Planning. J. Rigas and T. Rigas were convicted, in *US v. John J. Rigas, et al.*, 02 Crim. 1236 (S.D.N.Y.)(LBS), of a total of eighteen counts of securities fraud, bank fraud and conspiracy to commit securities fraud, bank fraud, and making or causing to be made false statements in Commission filings.

Rigas Entities consist of approximately 63 various partnerships, corporations, or limited liability companies exclusively owned or controlled by members of the Rigas family. While approximately fourteen of the Rigas Entities were engaged in the ownership and operation of cable television systems and other related ventures (the “Rigas Cable Entities”), the balance, or approximately forty-nine of the Rigas Entities, were involved in businesses completely unrelated to cable television (the “Rigas Non-Cable Entities”), including, but not limited to, Christmas tree farming, interior design, furniture retailing, honey cultivation and sales, ownership of a National Hockey League team franchise, venture capital, residential and commercial landscaping, and film production by E. Rigas. Adelphia managed and maintained virtually every aspect of the Rigas Cable Entities, including maintaining their books and records on a general ledger system shared with Adelphia and its subsidiaries. Adelphia and the Rigas Entities, participated jointly in a cash management system (“CMS”) operated by Adelphia. This resulted in the commingling of funds among the Adelphia CMS participants, including Adelphia subsidiaries and Rigas Entities. As detailed below, the sharing by Adelphia and the Rigas Entities of the same management, general ledger system, and cash management system greatly facilitated the fraud at Adelphia.

The Co-Borrowing Credit Facilities: Since at least 1996, Adelphia negotiated and established various commercial loans, credit facilities, and other credit arrangements for its benefit and the benefit of the Rigas Cable Entities. Among these credit facilities were four facilities, dated respectively, March 29, 1996, May 6, 1999, April 14, 2000, and September 28, 2001, in which certain subsidiaries of Adelphia became co-borrowers with certain Rigas Cable Entities (the “Rigas Co-Borrowers”). Under the terms of these credit facilities (the “Co-Borrowing Credit Facilities”) the co-borrowers under each Facility constituted a “borrowing group” for that Facility and, as a group, prepared and submitted annually to the lending banks audited combined financial statements, including a balance sheet and an income statement. From December 31, 1996 through at least December 31, 2000, Deloitte audited the annual financial statements of each borrowing group and, in each instance, issued an audit report containing an unqualified opinion on those financial statements. Also, under the terms of the Co-Borrowing Credit Facilities, each co-borrower had the ability to borrow up to the entire amount of the available credit under the applicable Facility and was jointly and severally liable for the entire outstanding balance under that Facility.

## **B. SUMMARY**

This case concerns a critically flawed audit by Deloitte. Deloitte did not act in accordance with Generally Accepted Auditing Standards (“GAAS”) and it failed to detect a massive fraud perpetrated by Adelphia and the Rigases. From at least 1998 through March 2002, at the direction of senior management, Adelphia transferred billions of dollars of liabilities to off-balance sheet affiliates, inflated earnings to meet Wall Street’s expectations, falsified operational statistics, and concealed varied instances of blatant self-dealing by the Rigases. On March 27, 2002, Adelphia revealed that it was jointly and severally liable for approximately \$2.3 billion (as of December 31, 2001) of bank loans incurred by the Rigas Entities. Revelations of further fraud followed: in addition to understating co-borrowing debt on its balance sheet, Adelphia had also overstated its operational and financial performance and concealed rampant self-dealing by the Rigases. As the fraud became known, Adelphia’s share price plummeted, erasing as much as \$8 billion of shareholder value.

Deloitte served as Adelphia’s independent auditor during the course of the misconduct and each year issued audit reports containing unqualified opinions on Adelphia’s annual financial statements filed with the Commission on Form 10-K. Adelphia’s Form 10-K for the 2000 fiscal year (the “Relevant Period”) contained significant material misstatements. In its Form 10-K for 2000, Adelphia understated its subsidiary debt by \$1.6 billion, overstated equity by at least \$368 million, and improperly netted related party receivables and payables between Adelphia and the Rigas Entities. Adelphia further failed to disclose the nature and extent of related party transactions between Adelphia and the Rigases. The Deloitte engagement team’s failure to object to these particular misstatements permitted Adelphia to engage in certain accounting practices that departed from Generally Accepted Accounting Principles (“GAAP”). Accordingly, Deloitte caused Adelphia’s violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

## **C. FACTS**

### **Deloitte’s Risk Management Program**

During the Relevant Period, Deloitte had a Risk Management Program for clients deemed to have “much greater than normal” audit risk. This program was not required by GAAS but was instead established by Deloitte for the purpose of better managing risks inherent in its audits of certain higher risk clients. According to Deloitte’s Accounting and Audit Procedures Manual (“AAPMS”), in effect during the Relevant Period, a client’s level of audit risk represented a measure of the possibility that fraudulent financial reporting or misappropriation of assets might have occurred at a client during the period being audited. Under the Risk Management Program guidance issued to Deloitte personnel, a Deloitte partner designated as a Special Review Partner was to provide an additional level of consultation and review beyond that provided by the engagement team. This Special Review Partner’s duties included (i) discussing specific risk areas and plans to respond to them; (ii) consulting with the engagement and concurring partners; (iii) reviewing the audit workpapers concerning risk areas of the engagement; and (iv) reviewing the

financial statements and Deloitte's audit report with an emphasis on the identification of specific risk areas as well as the adequacy of the audit report and disclosures regarding these risk areas. At the end of an engagement, the Special Review Partner was to complete a memorandum to Deloitte's National Office confirming that he had completed his duties as Special Review Partner and assessing whether adequate attention and resources had been dedicated to the management of the risks of the engagement.

### **Deloitte Recognized that Adelphia Was Among Its Highest Risk Clients**

As part of its annual audit planning process, Deloitte assessed the level of Adelphia's audit risk. From at least 1998, Deloitte concluded that Adelphia presented "much greater than normal" audit risk, which was the highest level of risk that Deloitte could assign to any client under guidelines set forth in the AAPMS. In reaching this conclusion, Deloitte identified a number of what it called "pervasive risk factors" posed by the Adelphia audit as a whole and "specific risks" associated with particular account balances examined during the audit. This risk assessment was reviewed by the Special Review Partner, who, in this case, had National Office clearing authority. Many of the pervasive risk factors and the specific risks were directly associated with Adelphia's extensive relationship with the Rigases and Rigas Entities, as well as its heavy reliance on debt and equity funding for its operating and capital needs. Among the pervasive risk factors identified by Deloitte in 2000 were:

- Management is dominated by one strong personality or concentrated in a small group without compensating controls.
- Management appears willing to accept unusually high levels of risk.
- Management tends to interpret accounting standards aggressively.
- The organizational [and/or reporting] structures are unduly complex.
- There is substantial debt from unusual sources (e.g., related parties) or on unusual terms.
- There are significant affiliated entities or other related parties that we will not audit and with whom significant transactions might have occurred.
- [Adelphia] engages in unique, highly complex and material transactions that pose difficult "substance over form" questions.
- [Adelphia] is under significant pressure to obtain additional capital necessary to stay competitive, and is growing and is near the limit of its financial resources.
- There have been frequent disputes with Deloitte . . . on accounting, auditing, or reporting matters.

Deloitte further identified “specific risks” including “numerous related party transactions” and observed that because “[Adelphia and its subsidiaries] are highly leveraged, compliance with debt covenants is critical to the operations of these entities.” Deloitte considered these “specific risks” as affecting, among others, Adelphia’s account balances for “notes payable, long term debt and interest” and “cash.” The “specific risks” identified for the 2000 Audit were communicated to Deloitte’s National Office.

Despite Adelphia’s risk level, Deloitte failed to tailor an audit approach that adequately responded to the risks identified in Deloitte’s audit planning. Moreover, Deloitte did not implement appropriate follow-up procedures to make sure not only that the audit testing and fieldwork used in the audit mitigated Adelphia’s audit risk, but also that the quality control protections intended to be provided by the presence of both Concurring and Special Review Partners actually functioned as those controls were designed to work in the circumstances of a high risk client audit.

### **Deloitte Failed to Ensure that Adelphia’s Disclosure of its Liabilities Was Proper**

Under the terms of the Co-Borrowing Credit Facilities, Adelphia and the Rigas Co-Borrowers each contributed various assets as collateral for the extension of credit. While it appears that the Rigas Co-Borrowers contributed approximately 66% of the total collateral underlying the 1996 Co-Borrowing Credit Facility, in 1999 to 2001, the Rigas Co-Borrowers contributed significantly less collateral – 19% in 1999 and 4% in both 2000 and 2001. The balance of the collateral was contributed by Adelphia subsidiaries. During the Relevant Period, Deloitte audited the annual financial statements of each borrowing group and in each instance issued an audit report containing an unqualified opinion on those financial statements. As of December 31, 2000, the total borrowing capacity under the three Co-Borrowing Credit Facilities then in existence was \$3.751 billion.

As of December 31, 2000, the Co-Borrowing Credit Facilities were completely drawn-down. Of the \$3.751 billion outstanding, approximately \$1.6 billion of Co-Borrowing debt was improperly excluded from Adelphia’s balance sheet for the year-ended 2000 as an Adelphia liability. Moreover, Adelphia’s 2000 Form 10-K included a footnote disclosure that was at best ambiguous and was misleading in that it suggested that all of the debt for which Adelphia was liable, including the \$1.6 billion owed by the Rigas Co-Borrowers, was properly reflected on Adelphia’s balance sheet. This amount represented over 28% of Adelphia’s reported bank debt and nearly 10% of Adelphia’s reported total liabilities.

Adelphia’s rationale to Deloitte for excluding \$1.6 billion in debt from its balance sheet was that it was a mere “guarantor” of the Rigas Co-Borrowers, and therefore did not have to reflect such debt as a liability on its balance sheet. Adelphia, however, provided Deloitte’s engagement team copies of the agreements underlying the Co-Borrowing Credit Facilities, which revealed that Adelphia was jointly and severally liable for the full amount of such debt. Deloitte’s engagement team failed to recognize this discrepancy or to take steps to understand the impact of joint and several liability.

Even under Adelphia's characterization of the debt as a "guarantee," Deloitte's engagement team knew or should have known that Adelphia did not perform the assessments required under Statement of Financial Accounting Standards No. 5 ("FAS 5") to determine if its potential contingency for the amount of co-borrowing debt that it excluded from its balance sheet was "probable" or even "reasonably possible" under FAS 5 and would have had to be disclosed.<sup>4</sup> Indeed, other than a cursory calculation not documented in the workpapers, Deloitte did nothing to determine whether the Rigas Entities had the financial wherewithal to repay the debt. In any event, Deloitte should have known that Adelphia had an obligation to disclose this debt even if it determined that its loss contingency was "remote."

In addition, during the 2000 Audit, Deloitte repeatedly proposed disclosure of the full amount of the Co-Borrowing debt. Deloitte inserted more explicit disclosure, including the amount of Rigas Co-Borrowing debt, in at least six drafts of Adelphia's 2000 Form 10-K. But when Adelphia's management resisted, Deloitte abandoned its attempts to make the disclosure more accurate.

Deloitte knew or should have known that Adelphia's failure to include all Co-Borrowing debt on its balance sheet, or to otherwise disclose that a portion had been excluded, did not conform to GAAP.

### **Deloitte Knew or Should Have Known That the \$1.6 Billion Was Adelphia's Liability and Should Have Been Reflected in its Financial Statements**

Adelphia's exclusion of Co-Borrowing debt from its balance sheet was also improper because virtually all of the Co-Borrowing debt excluded was in fact Adelphia's liability that had been improperly shifted from Adelphia's books to the books of the Rigas Co-Borrowers. Adelphia excluded Co-Borrowing debt from its balance sheet in a number of ways. It: (i) "reclassified" some debt to the books of the Rigas Co-Borrowers through the use of sham journal entries, (ii) improperly transferred debt in connection with direct placements of Adelphia

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<sup>4</sup> FAS 5 requires a company to include a contingent amount in its financial statements when that contingency is "probable." Paragraphs 10 and 11 of FAS 5 provide guidance on when a contingency needs only to be disclosed by a company in footnotes to its financial statements. Paragraph 10 provides, in pertinent part, that: "[d]isclosure of the contingency shall be made when there is at least a *reasonable possibility* that a loss or an additional loss may have been incurred . . ." [Emphasis added]. Under these principles, even if a loss contingency does not meet the threshold for inclusion in a company's financial statements, disclosure of the contingency is still required where there is a reasonable possibility of having to incur a liability under the contingency. Paragraph 12 of FAS 5 goes further and states that when a contingency is a guarantee of indebtedness of others—which Adelphia claimed the Rigas Co-Borrowing debt was—a company should nevertheless disclose the nature and amount of the guarantee even if the guarantee is assessed as "remote."

securities to the Rigases (approximately \$513 million in 2000); and (iii) recorded debt only on the books of the Rigas Co-Borrowers without appropriate extinguishment of Adelphia's liability, even though Adelphia remained ultimately liable for such debt.

Adelphia's practice of reclassifying or otherwise transferring Co-Borrowing debt from its books was improper. This practice had the effect of transforming Adelphia's Co-Borrowing debt into affiliate payables. This in turn reduced Adelphia's disclosed Co-Borrowing debt and created a means for Adelphia to conceal its ever-growing balance of affiliate receivables from Rigas Entities and individual Rigases. These affiliate receivables were the result of the Rigases' fraudulent draining of Adelphia's cash and other resources. By netting the fake affiliate payables against the affiliate receivables, Adelphia hid the existence of these receivables from investors, and reduced the amount of Co-Borrowing debt recorded on its books and records, thereby facilitating Adelphia's access to the capital markets.

Adelphia's practice of drawing down co-borrowing funds into an Adelphia bank account but recording debt on the books of the Rigas Co-Borrowers was equally improper. Such practices did not conform to GAAP, which requires that certain requirements be met before a liability can be extinguished. Deloitte knew or should have known that this practice was a violation of GAAP.<sup>5</sup>

Deloitte failed to recognize numerous red flags that indicated the existence of fraudulent entries throughout Adelphia's general ledger. For example, the general ledger included millions of dollars in payments to individual Rigases, a cost center for Doris Rigas's design company, and a \$375 million receivable from a Rigas entity that had purchased Adelphia stock in a direct placement. If Deloitte had conducted a more careful review of the relationship between the payables and receivables, it would have been able to determine that a large portion of the subsidiary debt should have remained on Adelphia's books. The result of Adelphia's fraudulent conduct was that the Rigases were able to loot Adelphia at the expense of Adelphia's shareholders and Adelphia was able to falsely represent that it was de-leveraging.

### **Deloitte Improperly Failed to Object to Adelphia's Netting of Related Party Payables and Receivables**

Adelphia was required by Regulation S-X paragraphs 210.5-02.3 and 210.5.02.19 to report related party receivables and payables as gross numbers on its balance sheet. Generally, and except in limited circumstances and in the absence of an explicit and legal right of offset,

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<sup>5</sup> Statement of Financial Accounting Standard No. 125 (FAS 125) required that once Adelphia drew down on the Co-Borrowing Credit Facilities, it had to either pay off the debt by the transfer of assets to the creditor or be legally released as primary obligor by the creditor, neither of which occurred. Attempting to "extinguish" debt by "assigning" it to a related party is not sufficient—the creditor must be paid or must legally release the borrower. (FAS 125 was superseded by FAS 140, effective March 31, 2001.)



Regulation S-X requires that certain information about related party receivables and payables be disclosed on the balance sheet.

The information that should appear on the face of the balance sheet or related notes and is required in SEC filings by Regulation S-X as separately stated line items (S-X at 210.05-02) includes: (1) amounts receivable from related parties (S-X at 210.05-02.3(a)(2)); and, (2) amounts payable to related parties (S-X at 210.05.02.19(a)(5)). In addition, if the amounts due are not current then Regulation S-X requires separate disclosure of "Indebtedness of related parties - not current" (S-X at 210.05-02.11) and "Indebtedness to related parties - not current" (S-X at 210.05-02.23).

Further, Accounting Research Bulletin 43, Chapter 1 at paragraph 5 states "Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately . . ." Accordingly, Adelpia was required both by GAAP and by Commission regulations to report related party transactions with the Rigas Entities in a gross presentation.

Adelpia improperly netted, or offset, related party payables and related party receivables as of year-end, and presented only that net balance on its balance sheet in a line item called "Related-party Receivables—Net." This practice did not conform to GAAP, obscured the extent and magnitude of Rigas self-dealing and assisted Adelpia in creating the appearance of de-leveraging. Paragraph 7 of Accounting Principles Board Opinion No. 10 ("APB 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." Financial Accounting Standards Board Interpretation No. 39 ("FIN 39"), in turn, defines a right of setoff as "a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor." FIN 39 sets forth four conditions that must be met for netting to be proper:

- (a) Each of *two* parties owes the other determinable amounts;
- (b) The reporting party has the right to set off the amount owed with the amount owed by the other party;
- (c) The reporting party intends to set off; and
- (d) The right to set off is enforceable at law.

(Emphasis in original)

Adelpia's practice of netting was a fraudulent device used to conceal its liabilities. No agreements, written or otherwise, existed that established any legal right by Adelpia to setoff amounts owed to it by the Rigas Entities or individual Rigases. Adelpia netted unrelated non-mutual balances without any attempt to match affiliate receivables with affiliate payables to the appropriate entities. Deloitte's failure to challenge Adelpia's practice of netting and its issuance of an audit report containing an unqualified opinion on the December 31, 2000 financial statements permitted Adelpia to reflect a mere \$3 million net receivable in its 2000 Form 10-K. If Deloitte had taken the appropriate action to correct Adelpia's disclosure, however, Adelpia would have had to report that, as of the year-ended December 31, 2000, Adelpia had gross related party

receivables of \$1.3513 billion and gross related party payables of \$1.348 billion, much more relevant numbers.

### **Deloitte Failed to Object to Adelphia's Overstatement of its Stockholders' Equity**

On January 24, 2000, a Rigas Entity acquired \$368 million of Adelphia Class B shares, purportedly paid in immediately available funds. In fact, the Rigas Entity paid nothing and Adelphia booked an affiliate receivable from that entity for the purchase price of the shares. This receivable was never satisfied for cash but, along with other affiliate receivables, was netted against and reduced by the fake affiliate payables created by Adelphia's reclassification. Certain members of Deloitte's engagement team were aware of a \$375 million receivable (\$7 million of which was actually paid) created in connection with this purchase. Such a receivable created a stock subscription, which should have resulted in Adelphia recording a \$375 million contra-equity (a direct decrease to equity). Instead, through its failure to object, Deloitte allowed Adelphia to overstate its stockholders' equity by \$368 million, thereby improving Adelphia's overall financial picture.

### **Deloitte Failed to Address Each Risk Factor Identified By its Risk Management Program**

At the conclusion of the 2000 audit, notwithstanding that Deloitte had identified nine specific audit risks, Deloitte failed to do any meaningful assessment of whether those risks had been appropriately addressed. Rather, Deloitte did a cursory review of the audit plan and the risk factors and decided, with no further analysis, that the risk factors had been adequately addressed. This failure to follow up on the enumerated risk factors resulted in Deloitte's oversight of numerous red flags described above that indicated the existence of Adelphia's fraud.

### **Adelphia's Violations**

Section 13(a) and Rules 13a-1 and 13a-13 of the Exchange Act require issuers to file annual and quarterly reports with the Commission and to keep this information current. Rule 12b-20 requires disclosure of such additional information as may be necessary to make the required statements not misleading. Implicit in these provisions is the requirement that the information reported be true, correct and complete. See United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991); SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978).

As described above, Adelphia misstated its total liabilities, equity, and related party receivables in its 2000 Form 10-K. Accordingly, Adelphia violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13.

Adelphia also violated Section 13(b)(2)(A) of the Exchange Act by failing to make and keep books, records, and accounts that accurately, and in reasonable detail, reflected transactions and dispositions of its assets or liabilities. In addition, Adelphia failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP, thereby violating Section 13(b)(2)(B) of the Exchange Act. Adelphia's internal controls

were not sufficient to prevent the recording of numerous false journal entries, specifically the quarterly reclassification of debt, without proper basis or support.

#### **D. DELOITTE'S IMPROPER PROFESSIONAL CONDUCT**

By virtue of the conduct alleged above, Deloitte failed to conduct its audit of Adelphia's 2000 financial statements in accordance with GAAS. Rather, Deloitte issued an audit report containing an unqualified opinion on Adelphia's 2000 financial statements while it knew or should have known that Adelphia: (a) failed to record all co-borrowing debt on its balance sheet or otherwise disclose that a portion had been excluded; (b) failed to disclose significant related party transactions by improperly netting related party payables and receivables; and (c) overstated its stockholders' equity by \$375 million. Moreover, Deloitte failed to tailor an audit approach that adequately responded to the risks identified in Deloitte's planning of its audit of Adelphia's 2000 financial statements.

GAAS requires that auditors exercise due professional care in performing an audit and in preparing the audit report. AU § 230.01. Due professional care requires that the auditor exercise professional skepticism in performing audit procedures and gathering and analyzing audit evidence. AU § 230.07-.08. "In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." AU § 230.09. Moreover, GAAS requires that an auditor must obtain "sufficient competent evidential matter" to provide "a reasonable basis for forming an opinion." AU §326.22.

More specifically, when auditing a client identified to be at higher risk for material misstatement of the financial statements, GAAS makes clear that "the auditor should consider this conclusion in determining the nature, timing, or extent of procedures." AU §312.17. GAAS further states that "[h]igher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence." *Id.* GAAS also requires that professional skepticism increase with a higher level of risk assessment. As set forth in paragraph 27 of SAS 82, "examples demonstrating the application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud include (a) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (b) 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."<sup>6</sup>

Deloitte departed from the applicable GAAS provisions cited above by failing to exercise due professional care and skepticism and obtain sufficient competent evidential matter; substituting management representations for competent evidence; failing to take appropriate action to correct Adelphia's inconsistent and deficient disclosure; and issuing inaccurate audit reports.

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<sup>6</sup> SAS 82 has been superseded by SAS 99 (AU § 316.46) which became effective for audits of financial statements for the periods beginning on or after December 15, 2002.

In addition to its departure from GAAS, Deloitte caused Adelphia's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. Adelphia could not have filed its misleading 2000 Form 10-K without Deloitte's audit report. By failing to detect the fraud and issuing an audit report on Adelphia's financial statements that incorporated the company's violations of GAAP, yet stating that such financial statements "presented fairly, in all material respects" Adelphia's financial condition and results of operations, Deloitte caused Adelphia's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

As Adelphia's auditor, and for the purpose of determining the extent of reliance that Deloitte's engagement team could place in Adelphia's systems, Deloitte evaluated Adelphia's internal controls pursuant to GAAS. Deloitte made use of its knowledge of Adelphia's internal controls in planning the scope, timing, and substance of the audit work. Deloitte knew or should have known that Adelphia's books and records did not accurately reflect transactions (such as co-borrowing debt, Rigas securities purchases and other related party transactions). Further, Deloitte knew or should have known that Adelphia had significant flaws in its internal controls. Accordingly, by failing to recognize and object to the significant flaws in Adelphia's books and records and internal controls, Deloitte caused Adelphia's violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

## **E. FINDINGS**

Based on the foregoing, the Commission finds that Deloitte engaged in improper professional conduct in connection with the 2000 Adelphia audit pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice by engaging in 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.

## **F. CERTAIN STEPS TAKEN BY DELOITTE SINCE THE ADELPHIA AUDIT**

Deloitte now uses a proprietary financial analysis tool ("Deloitte Radar" or "DDAR") to assist in its assessment of substantially all of its U.S. public company clients with publicly traded equity securities as to their potential for financial statement fraud or business failure. This information is used by Deloitte in planning its risk-based audit procedures, including Deloitte's assessment of whether a client should be included in the Risk Management Program.

After May 2002, but before the entry of this Order, for the audits of public companies placed in the Risk Management Program, Deloitte established and implemented the following enhancements to its audit policies and procedures:

a. Deloitte now notifies the Audit Committee about a client's placement in the Risk Management Program.

b. Deloitte forensic specialists are now involved in the audit planning for certain clients in the Risk Management Program that are determined by Deloitte to be at a high risk of fraud. The Audit Engagement Partner also retains the discretion to have Deloitte forensic specialists involved in audit planning in other audits in the Risk Management Program.

c. The Audit Engagement Partner now conducts a detailed review of the principal audit workpapers and the Concurring Partner must do an overriding review.

d. At the conclusion of the audit of clients in the Risk Management Program the engagement team must document its conclusions about the effectiveness of audit response to identified audit risks, and the Special Review Partner must concur.

e. Deloitte now develops and documents circumstances specific to each particular client under which the client would be permitted by Deloitte to exit the Risk Management Program.

## **G. UNDERTAKINGS BY DELOITTE**

1. Upon submission of its Offer, Deloitte will deposit \$25 million into an escrow account. Within 10 days of the date of this order, those funds shall be paid to the Clerk of the United States District Court for the Southern District of New York, together with a cover letter identifying Deloitte as the defendant in *SEC v. Deloitte* 05 Civ. 4119 (S.D.N.Y), and specifying that the payment is made in connection with the Commission's administrative proceeding. Deloitte shall simultaneously transmit photocopies of such payment and letter to Helene T. Glotzer, Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281. By making this payment, Deloitte relinquishes all legal and equitable right, title, and interest in such funds, and no part of the funds shall be returned to Deloitte. Once the Respondent has paid these funds pursuant to this Order, the Respondent shall have no further obligation, liability or responsibility with respect to these funds. The Clerk shall deposit the funds into an interest bearing account. These funds, together with any interest and income earned thereon (collectively, the "Fund"), shall be held until further order of the Court. In accordance with the guidelines set by the Director of the Administrative Office of the United States District Courts, the Clerk is directed, without further order of the Court, to deduct from the income earned on the money in the Fund a fee equal to ten percent of the income earned on the Fund. Such fee shall not exceed that authorized by the Judicial Conference of the United States. The Commission may by motion propose a plan to distribute the Fund subject to the Court's approval. Such a plan may provide that the Fund shall be distributed pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002. Deloitte acknowledges that such funds will not be used to pay attorneys' fees in any private damages action brought against Deloitte by or on behalf of one or more Adelphia investors.

2. For audits of public companies placed in the Risk Management Program and commencing with audits of financial statements with a year-ended June 30, 2005, Deloitte will establish and implement the following policies and procedures:

a. Knowledgeable and experienced partners shall be appointed as Special Review Partners to oversee the planning and design of audit procedures for audit risks that have been identified in the planning stage of the audit, and these audit procedures will be specifically tailored to the particular audit risks identified in connection with the audit

b. Deloitte will utilize Deloitte forensic specialists in the planning stage of audits of all clients in the Risk Management Program.

c. Prior to the issuance of a Report of an Independent Public Accountant, the Engagement Partner will be responsible for the preparation of a written memorandum: (1) listing specific and pervasive audit risks identified at the planning stage of the audit as well as any significant issues that arose during the engagement; (2) describing procedures used to address each identified risk and issue; and (3) explaining why such procedures adequately address the risk or issue. The Special Review Partner will: (1) review the memorandum; (2) determine through review of the memorandum, inquiry of the Engagement Partner, and, if the Special Review Partner deems appropriate, review of certain workpapers, whether the Special Review Partner concurs with the view of the Engagement Partner that the procedures adequately addressed the risk or issue; and (3) document that concurrence in the workpapers.

d. The Engagement Partner and the Special Review Partner will review any significant issues arising during the audit to determine whether it is appropriate under the circumstances to consult with Deloitte's National Office about the issue. If consultation over such an issue occurs, the engagement team will ensure that the audit workpapers document any such consultation involving Deloitte's National Office.

3. Within 24 months from the date of this order, Deloitte will take reasonable steps to ensure that all Deloitte audit professionals have completed 8 hours of training on: (a) fraud detection; and (b) operation of, and an auditor's responsibilities under, Section 10A of the Exchange Act, based upon training materials approved by an individual or organization not unacceptable to the staff of the Commission. Training will include techniques in detecting or responding to possible fraud by audit clients, or by employees, officers or directors of audit clients.

4. Within ten days of the date of this Order, Deloitte shall distribute copies of the Order to all audit professionals.

5. Eighteen months from the date of this Order, Deloitte will retain, at its own expense, an independent consultant not unacceptable to the staff of the Commission, to review Deloitte's compliance with the undertakings set forth in this Section. The consultant will, within 120 days of commencing his/her review, provide a report of the results of that review to the staff of the Commission. In addition, Deloitte shall require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Deloitte, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also

provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in the performance of his/her duties under this Order shall not, without prior written consent of the Commission's staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Deloitte, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

6. The above policies and procedures are intended to enhance the procedures applied to those clients placed in the Risk Management Program and to enhance the training of Deloitte personnel. Both Deloitte and the Commission recognize that auditing standards and procedures are constantly evolving and improving, and that such developments may dictate that a change in approach from these undertakings may be appropriate. Accordingly at any time within the term of this order, Deloitte may make a request to the staff of the Commission's Office of the Chief Accountant to alter or modify these policies or procedures and the Office of the Chief Accountant will determine whether it is necessary or appropriate for the Commission to approve such a change.

#### **IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Deloitte's Offer.

Accordingly, IT IS HEREBY ORDERED, effective immediately, that Deloitte is censured pursuant to Rule 102(e) of the Commission's Rules of Practice.

By the Commission

Jonathan G. Katz  
Secretary