INITIAL DECISION RELEASE NO. 315
ADMINISTRATIVE PROCEEDING
FILE NO. 3-12064

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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| In the Matter of | : | |
| | : | INITIAL DECISION |
| GREGORY M. DEARLOVE, CPA | : | July 27, 2006 |
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APPEARANCES: Alistaire Bambach, Panayiota K. Bougiamas, Nancy A. Brown, and Jack Kaufman for the Division of Enforcement, Securities and Exchange Commission.

Robert J. Fluskey, Michelle Merola, Joseph V. Sedita, and Benjamin M. Zuffranieri, Jr., for Respondent.

BEFORE: James T. Kelly, Administrative Law Judge.

The Securities and Exchange Commission (SEC or Commission) issued its Order Instituting Proceedings (OIP) on September 30, 2005, pursuant to Section 21C of the Securities Exchange Act of 1934 (Exchange Act) and Rule 102(e) of the Commission's Rules of Practice.

Gregory M. Dearlove, CPA (Dearlove), formerly a partner with Deloitte & Touche LLP (Deloitte), served as engagement partner on Deloitte's audit of the financial statements of Adelphia Communications Corporation (Adelphia) for the year ended December 31, 2000 (2000 Financial Statements). The OIP contends that Adelphia's 2000 Financial Statements were materially false and misleading and failed to comply with Generally Accepted Accounting Principles (GAAP). It further asserts that the audit Dearlove planned, directed, and supervised was not conducted in accordance with Generally Accepted Auditing Standards (GAAS).[1]

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[1] Generally Accepted Accounting Principles are the basic postulates and broad principles of accounting pertaining to business enterprises. These principles establish guidelines for measuring, recording, and classifying the transactions of a business entity. Generally Accepted Auditing Standards are the standards prescribed for the conduct of auditors in the performance of an examination of management's financial statements. See SEC v. Arthur Young & Co., 590 F.2d 785, 788-89 nn.2 & 4 (9th Cir. 1979).

Dearlove signed a report stating that Deloitte had conducted its audit in accordance with GAAS, that Adelphia had prepared its financial statements in conformity with GAAP, and that the financial statements fairly presented Adelphia's financial condition. As a result, the OIP alleges that Dearlove engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

The OIP also charges that Adelphia, a non-party, misstated its total liabilities, equity, and related-party receivables in the 2000 annual report it filed with the Commission on Form 10-K. It further alleges that Adelphia failed to make and keep books, records, and accounts that accurately reflected transactions and dispositions of its assets or liabilities. Finally, the OIP contends that Adelphia failed to devise and maintain a system of internal accounting controls that provided reasonable assurances against the recording of numerous false journal entries. As a result, the OIP asserts that Adelphia violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 13a-1 and 12b-20 thereunder, and that Dearlove caused these violations.

The Commission's Division of Enforcement (Division) seeks to bar Dearlove from appearing and practicing before the Commission. It also requests an order requiring Dearlove to cease and desist from causing violations of the relevant provisions of the Exchange Act and the Commission's implementing regulations, and to disgorge the compensation he earned in connection with the audit. Dearlove maintains that the charges lack merit and should be dismissed.

I held nine days of public hearings in New York City during January and February 2006.[2] The Commission's Office of Chief Accountant (OCA) did not enter an appearance.[3] The parties then filed proposed findings of fact, proposed conclusions of law, and supporting briefs.

**FINDINGS OF FACT**

I base my findings and conclusions on the entire record and on the demeanor of the witnesses who testified at the hearing. I applied "preponderance of the evidence" as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). I have considered and rejected all arguments, proposed findings, and proposed conclusions that are not discussed in this decision.

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[2] The hearing transcript, as amended by the parties' stipulations and my Order of February 27, 2006, will be cited as "Tr. ___." The Division's exhibits will be cited as "DX ___." Respondent's exhibits will be cited as "RX ___."

[3] Disciplinary proceedings against accountants originate with a recommendation to the Commission by OCA. 17 C.F.R. § 200.22. Prosecution responsibility has rested with the Division since December 1993. See SEC News Release No. 93-62 (Dec. 9, 1993). Although this OIP was based on allegations by the Division and OCA, counsel entered their appearances only for the Division (Letters from Division counsel to ALJ, dated Oct. 7, 2005). OCA did not join the Division's pleadings.

### A. Background

Adelphia and the Rigas Family

In 2000, Adelphia was a public company engaged primarily in the cable television business (Tr. 10, 426-27). It had several large subsidiaries, some of which were also public companies (Tr. 10-11). Adelphia's principal office was in Coudersport, Pennsylvania (DX 31 at 1). John Rigas and his family were Adelphia's controlling shareholders (Tr. 11, 427).

Adelphia's certificate of incorporation authorized two classes of common stock, Class A and convertible Class B (DX 31 at 82; RX 6 at 80). Until 2002, Adelphia's Class A common stock was quoted on the NASDAQ National Market System (DX 31 at 33; RX 6 at 33). Adelphia's Class B common stock was never publicly traded. Rather, it was owned exclusively by members of the Rigas family (DX 31 at 33; RX 6 at 33). Holders of Class A and Class B common stock voted as a single class on all matters submitted to a vote of the stockholders (DX 31 at 82; RX 6 at 80). However, holders of Class B common stock were entitled to ten votes per share, while holders of Class A common stock were entitled to one vote per share (Tr. 1122, 1490; DX 31 at 82; RX 6 at 80). Thus, the Rigas family exercised voting control of Adelphia's common stock. Whenever Adelphia raised capital by issuing Class A shares, the Rigases would arrange for Adelphia to make a direct placement of Class B shares, so that their voting interests and ownership would not be diluted (Tr. 231-33, 1079-80). In the annual election of directors, the holders of Class A common stock, voting as a separate class, were entitled to elect one of Adelphia's nine directors (Tr. 1123, 1753; DX 31 at 82; RX 6 at 80, RX 40 at 14).

John Rigas, his three sons, and his son-in-law constituted a majority of Adelphia's board of directors and held all the senior executive positions at Adelphia (Tr. 9-12, 136, 181, 427, 1757). John Rigas was Adelphia's founder, chairman, chief executive officer, and president (Tr. 12; DX 31 at 31; RX 6 at 32). Timothy Rigas served as Adelphia's executive vice president, chief financial officer, accounting officer, treasurer, and a director (Tr. 9-10, 136; DX 31 at 31; RX 6 at 32). Timothy Rigas was also chairman of Adelphia's audit committee (Answer ¶ 8; Tr. 1128-29, 1792, 1860; DX 38, DX 43).

The Rigas family also owned several dozen private companies (Rigas Entities) (Tr. 12-13). The largest of these companies were engaged in the cable television business (Rigas Cable Entities) and the Rigas family operated them in common with Adelphia (Tr. 12-13, 105, 1753-54). The fourteen Rigas Cable Entities had no employees of their own (Tr. 1755). They used Adelphia personnel, inventory, trucks, and equipment to provide cable service to their customers (Tr. 1755-56). Nonetheless, the Rigas Cable Entities had their own assets (Tr. 185-86). There is no suggestion that they were mere corporate shells. Several other Rigas Entities were not involved in the cable television business (Tr. 12-13, 428-29, 1754).

Adelphia, its subsidiaries, and the Rigas Entities shared a centralized treasury system that employed a computerized general ledger (Tr. 13, 104-05, 387-88, 429-30, 737-38).[4] The computerized general ledger was structured around cost centers that separately recorded the cash balances of each individual entity. Adelphia employees used these internal accounts to track and accumulate the financial transactions among Adelphia, its subsidiaries, and the Rigas Entities (Tr. 387-88). Adelphia charged the Rigas Entities a fee for performing management and bookkeeping services (Tr. 1758-59; DX 31 at 90, DX 156 at 12; RX 193 at 15).

The Co-Borrowing Credit Agreements

Adelphia had doubled in size during 1999 by acquiring a series of cable companies (Tr. 13, 431, 676, 1698; DX 31 at 37). It continued to grow during 2000 through additional acquisitions (Tr. 1099-1100; DX 31 at 37, 49-50, 64-66). The financing transactions associated with these acquisitions significantly increased the size of Adelphia's debt.

Beginning in 1996, Adelphia, its subsidiaries, and some of the Rigas Cable Entities entered into three credit agreements for their collective benefit with a consortium of banks (Tr. 13-14, 439-40, 676-77; DX 18, DX 19, DX 60; RX 15). Under the successively larger agreements, dated March 1996 ($200 million), May 1999 ($850 million), and April 2000 ($2.25 billion), certain subsidiaries of Adelphia became co-borrowers with certain Rigas Cable Entities (Tr. 14-16, 18-25, 439, 1098-1100, 1700-01).[5]

The 1996 agreement was initially negotiated by a Rigas Cable Entity and later amended to allow an Adelphia subsidiary to participate as a co-borrower (Tr. 1098-99, 1102). In 1999, Adelphia's subsidiaries purportedly obtained a more favorable interest rate than the participating Rigas Cable Entity could have obtained on its own (Tr. 1000). Both the 1999 and 2000 agreements purportedly gave the participating Rigas Cable Entities access to substantially more funds than they could have borrowed on a stand-alone basis (Tr. 187).[6] See infra p. 17.

Under the terms of these co-borrowing agreements, each borrower contributed various assets, including cable systems and the right to paying cable customers, as collateral for the extension of credit to the borrowing group as a whole. All three lending agreements provided that each of the co-borrowers was jointly and severally liable for the full amount borrowed,

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[4] The OIP refers to this centralized treasury system as the "cash management system" or "CMS." However, Adelphia and Deloitte did not use the terms "cash management system" or "CMS" during 2000 or 2001 (Tr. 429-30, 476, 607-08, 737-38, 1954). When the context permits, this Initial Decision will use the terminology employed during 2000-2001.

[5] As used in this Initial Decision, a co-borrowed credit facility is a single loan arrangement that covers multiple borrowers (Tr. 14, 439). Each borrower provides collateral for the loan, and each can draw proceeds under the loan (Tr. 14, 439).

[6] The 2000 credit facility of $2.25 billion was later increased by another $500 million (Tr. 1791). Thus, the total amount of credit available under the three agreements was $3.8 billion.

regardless of which co-borrower drew down the money (Tr. 16, 440, 1256-59; RX 20).[7] Each co-borrower could draw down the full amount of the credit available under each agreement (Tr. 192, 678).

The three facilities combined the features of term loans and revolving credit agreements, which meant that the co-borrowers could draw down funds and repay them at will (Tr. 1789-90). As a result, the amount outstanding under the agreements could fluctuate (Tr. 624-25, 936-37, 1788). The agreements needed to be renewed or refinanced before their maturity dates. However, minimal or no principal repayments were due until the maturity dates (Tr. 1271, 1273, 1470-73, 1768). The three credit agreements did not require any repayment of principal during 2000 or 2001 (Tr. 1271-73, 1768; DX 18 at 31-32, DX 19 at 43).

The agreements included "change of control" provisions. Thus, it would be an event of default if the Rigases lost a voting majority of Adelphia stock (Tr. 48-52; DX 18, DX 19, DX 60). The agreements also contained acceleration clauses that allowed the lenders to declare the entire amounts then outstanding due and payable in the event of default (Tr. 1274, 1894).

By December 31, 2000, the co-borrowers had drawn down $3.751 billion of the $3.8 billion available under the three credit agreements (DX 24, DX 25, DX 48 at DT 107074-75; RX 25.1).[8] The amount drawn at the end of 1999 had been $1.025 billion (Tr. 440).

Adelphia's consolidated balance sheet included only that portion of the debt that Adelphia and its wholly owned subsidiaries had drawn, and excluded that portion that the participating Rigas Cable Entities had drawn (Tr. 26, 121-22, 350, 440, 443, 1765). Thus, Adelphia included on its December 31, 2000, balance sheet approximately $2.1 billion of the $3.751 billion of the debt and excluded approximately $1.6 billion of the debt (Tr. 680).

At the end of December 1999, Adelphia's Class A common stock closed at $65.62 per share. At the end of December 2000, Adelphia's Class A common stock closed at $51.62 per share (Tr. 96). See http://finance.yahoo.com/q/hp?s (official notice).

Deloitte and Dearlove

Deloitte is a Delaware limited liability partnership headquartered in New York City (Answer ¶ 6). It had served as independent auditor for Adelphia since 1980, well before

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[7] Black's Law Dictionary 926 (7th ed. 1999) defines joint-and-several liability as liability that "may be apportioned either among two or more parties or to only one or a few select members of the group, at the adversary's discretion. Thus, each liable party is individually responsible for the entire obligation, but a paying party may have a right of contribution and indemnity from the nonpaying parties."

[8] OIP ¶ II.C.16 alleges that all three credit agreements were completely drawn down as of December 31, 2000. However, only $151 million of the $200 million available under the 1996 agreement was then drawn down (Tr. 19, 1789; DX 86.15).

Adelphia became a public company (DX 11). Adelphia was one of Deloitte's largest clients (Tr. 418, 1734). At the relevant times, Deloitte staffed the Adelphia audit primarily through its Pittsburgh, Pennsylvania, office (Tr. 508-09).

Dearlove, age fifty-two, resides in Orchard Park, New York (Tr. 1719-20). He earned a BSBA degree from the State University of New York at Buffalo and has been licensed as a certified public accountant (CPA) by the State of New York since 1978 (Answer ¶ 48; Tr. 1721). Dearlove was a partner in Deloitte and its predecessor firms from June 1986 through September 2001 (Tr. 1723, 1924).

Dearlove was the managing partner of Deloitte's Buffalo office from 1997 to 1999 (Tr. 1724-25, 1727, 1731). Before serving as the partner in charge of Deloitte's audit of Adelphia's 2000 Financial Statements, Dearlove had been engagement partner for the audit of ten public companies and concurring review partner on additional accounts (Tr. 1729, 1732).

### B. Deloitte's Audit of Adelphia's 2000 Financial Statements

Deloitte Assigns Dearlove
to the Adelphia Engagement

In 1999 and 2000, the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA) required member firms to rotate an engagement partner off the audit of a public company after seven consecutive years. See AICPA, SEC Practice Section Reference Manual § 1000.08(e). The purpose of the partner rotation rule is to bring a fresh perspective to the audit and help maintain auditor independence (Tr. 1715; Report of Elliot A. Lesser, CPA, dated Dec. 16, 2005, at 26 (Lesser Report)). By 1999, Don Cottrill (Cottrill) of Deloitte's Pittsburgh office had served for seven consecutive years as the partner in charge of Deloitte's audit of Adelphia (Tr. 693, 1737-38). Deloitte asked Dearlove to serve as the engagement partner for its audit of Adelphia's 2000 Financial Statements (Tr. 1732-36).

Dearlove visited Deloitte's Pittsburgh office in August and September 1999 to discuss the engagement with Cottrill and others (Tr. 506-07, 1735). He also visited Adelphia's headquarters in Coudersport, observed a quarterly review, and read an Adelphia securities registration statement (Tr. 1734, 1742). In October 1999, Dearlove agreed to accept the Adelphia assignment (Tr. 1732-36, 1741). At the time, Dearlove had approximately twenty-one years of experience as a CPA (Tr. 1721).

Dearlove became the engagement partner on January 1, 2000, but assumed full responsibility only with the first quarterly review in April and May 2000 (Tr. 426, 671, 1794-95). During the transition period (October 1999 to March 2000), Dearlove shadowed Cottrill. He also observed Deloitte's audit of Adelphia's 1999 Financial Statements and reviewed the work papers for the 1999 audit of FrontierVision Partners, L.P. (FrontierVision), an Adelphia subsidiary (Tr. 325-26, 489-91, 671, 775, 1746, 1748, 1772). After the completion of the 1999 audit, one of Deloitte's senior managers reviewed Adelphia's 1999 Financial Statements with Dearlove and explained the theory and history behind the accounting presentations (Tr. 1747-48).

The 2000 Audit Engagement

As engagement partner, Dearlove had overall responsibility for Deloitte's audit of Adelphia's 2000 Financial Statements (Tr. 414-15). He had final responsibility for supervising the engagement team, and for ensuring that the audit was conducted in accordance with GAAS and that Adelphia's financial statements conformed to GAAP (Tr. 519, 860-61, 979, 988, 1595-98, 1817-18).

Adelphia was a large company with a complex structure and the audit was demanding (Tr. 354, 421, 1519, 1742-43). Several of Adelphia's subsidiaries filed their own Forms 10-K and there were many reporting groups (Tr. 10, 421, 1742-43, 1821-22; Report of Vincent J. Love, CPA, dated Jan. 13, 2006, at 12 (Love Report)). Adelphia bought companies on a fairly regular basis and offered securities (Tr. 421).

For several years, Deloitte had considered the audit of Adelphia to present a much greater than normal risk of fraud, misstatement, or error (Tr. 416-17, 533, 672, 870, 981). Dearlove initially questioned the need for such an elevated risk assessment (Tr. 675-76). However, he and other Deloitte partners unanimously decided to continue that evaluation for the 2000 audit (Tr. 431-32, 675-76; DX 11, DX 86.1). Deloitte reached this risk assessment for several reasons. Among other things, Adelphia was highly leveraged and did business in an industry with rapidly changing technology. In addition, control of Adelphia was concentrated among a few people. There were numerous related-party transactions that arose outside the normal course of business. There were several affiliated entities that Deloitte would not audit and Adelphia might have engaged in significant transactions with these un-audited entities (Tr. 417-18, 435, 871, 982-83; DX 86.1; RX 127, Tab 3).

Neither Timothy Rigas, Adelphia's chief financial officer, nor James R. Brown (Brown), Adelphia's vice president of finance, were trained as accountants (Tr. 9, 187, 323). Adelphia management offered aggressive interpretations of accounting issues at times and was willing to argue its points (Tr. 425-26; DX 86.1). As a result, Adelphia and Deloitte sometimes had lengthy and repeated discussions about accounting issues (Tr. 425, 1852-53). When Timothy Werth (Werth), a CPA, became Adelphia's director of accounting in 2000, his supervisor suggested that he should take a "hands off" approach to dealing with Deloitte and leave sensitive issues to Brown (Tr. 189-90, 194-95).[9]

The 2000 engagement team remained largely intact from the prior year (Tr. 1741, 1824-25). William Caswell, CPA (Caswell), and Ivan Hofmann, CPA (Hofmann), assisted Dearlove. Caswell, a director at Deloitte, was an experienced senior manager on the 2000 audit (Tr. 413-14, 503-06). Hofmann was an audit manager and reported to Caswell and Dearlove (Tr. 668). Caswell and Hofmann had worked on Adelphia audits since 1994 (Tr. 413, 777). Michael

[9] It is now apparent that Adelphia management took steps to conceal information from the auditors. Adelphia kept a list of "exposure items" that it did not want Deloitte to discover (Tr. 70-71, 299-301, 396-97). Brown and Werth also admitted lying to the auditors (Tr. 83-84, 305, 308-09). Deloitte was not aware of the exposure list or the lying during the audit.

Lindsey, CPA (Lindsey), was Deloitte's concurring review partner (Tr. 670, 858, 961, 965). Stephen Biegel, CPA (Biegel), was Deloitte's risk review partner (Tr. 850). Lindsey and Biegel were not involved in the daily management of the 2000 engagement but were available for consultation on technical issues (Tr. 416, 670, 850, 882). Lindsey and Biegel had previously been involved in the 1999 Adelphia engagement as concurring reviewer and risk reviewer, respectively (Tr. 417, 538, 966).

Deloitte staffed its reviews of Adelphia's 2000 quarterly reports by assigning twelve to fifteen accounting professionals to Coudersport (Tr. 509-10). Dearlove spent two to four days at a time in Coudersport in connection with these quarterly reviews (Tr. 510, 1831). Deloitte assigned approximately thirty accounting professionals to Coudersport for the audit of Adelphia's 2000 Financial Statements (Tr. 510, 1823). Dearlove spent ten to fifteen days in Coudersport in connection with the 2000 audit (Tr. 511, 1831-32).

Deloitte devoted approximately 21,000 hours to the audit and related accounting advisory activities (Tr. 333-34; Love Report at 12). Dearlove spent approximately 710 hours (Tr. 1831; Love Report at 12). Deloitte billed Adelphia $1,319,000 for professional services in connection with the 2000 audit and the 2000 quarterly reviews (DX 158 at 22).

Deloitte's Unqualified Audit Opinion

Deloitte issued its independent auditors' report, addressed to Adelphia, on March 29, 2001 (DX 31 at 56-57). Dearlove signed the report on behalf of Deloitte (Answer ¶ 5; Tr. 1882-83; DX 78). The report stated that Deloitte had audited the consolidated balance sheets of Adelphia and its subsidiaries as of December 31, 1999 and 2000, in accordance with GAAS, and had obtained reasonable assurance that Adelphia's 2000 Financial Statements were free of material misstatements (DX 31 at 56). Deloitte opined that the consolidated financial statements presented fairly, in all material respects, the financial position of Adelphia and its subsidiaries at December 31, 1999 and 2000, and the results of their operations and cash flows for the years ended December 31, 1999 and 2000, in conformity with GAAP (DX 31 at 57).

Adelphia filed its 2000 annual report (Form 10-K) with the Commission on April 2, 2001 (DX 31). It filed an amended annual report (Form 10-K/A) with the Commission on April 30, 2001 (Tr. 1135-36; DX 156; RX 193). Dearlove reviewed Adelphia's Form 10-K/A, but Deloitte did not opine on it (Tr. 1132, 2257-58).

### C. Subsequent Developments

Deloitte's Internal Practice Review, the
Arahova Restatement, and Dearlove's Resignation

To monitor the quality of its audits of public companies, Deloitte conducts an internal practice review and qualitative review program (Tr. 602-04, 1901-02; RX 107). Through this program, experienced auditors from other Deloitte offices obtain an in-depth understanding of an engagement team's approach to a completed audit, as well as insight into the knowledge, skills, training, and experience of the engagement team (RX 107). In addition, the qualitative review

measures compliance with professional standards and firm policies in the areas reviewed (Tr. 1903-04, 1913-15; RX 107).

In June 2001, Deloitte's national office of quality assurance selected three audit engagements by the Pittsburgh office for qualitative review (Tr. 1901-02; RX 107). One of these engagements involved the 2000 audit of Arahova Communications, Inc. (Arahova), an Adelphia subsidiary that had filed its own Form 10-K (Tr. 164-65, 602-04, 656; RX 107).[10] Deloitte's practice reviewers gave the Arahova audit team three negative responses (Tr. 605-06, 1909; RX 111). According to Dearlove, the practice reviewers "felt very comfortable" with the quality of the Arahova engagement (Tr. 1911-12).

At Deloitte's urging, Arahova restated certain financial results in the summer of 2001 (Tr. 69-70, 164-65, 635-36, 659-60, 975, 1905).[11] Dearlove explained that the practice reviewers were aware that a restatement was under discussion in June 2001 but did not consider the potential restatement to be the result of an audit failure (Tr. 1910-12). Arahova's restatement did not change Adelphia's 2000 Financial Statements (Tr. 659-60, 975).

In September 2001, Dearlove resigned from Deloitte to accept a position as Chief Financial Officer and Senior Vice President of Finance for Computer Task Group, Inc. (CTG), an issuer of publicly traded securities (Tr. 1923-24; DX 1.1 at 67).[12] Deloitte appointed Paul O'Leary (O'Leary) to succeed Dearlove as the engagement partner for its audit of Adelphia's 2001 Financial Statements (Tr. 137, 1924).

### Adelphia Acquires More Cable Companies and More Debt in 2001

During 2001, Adelphia continued to undertake a series of acquisitions and financing transactions that dramatically increased the size of the company and its indebtedness (Tr. 47; DX 150 at 28, 161-62). For example, on September 28, 2001, Adelphia, its subsidiaries, and the Rigas Entities closed on a new $2.03 billion co-borrowed credit agreement (DX 151 at 10). At the same time, the co-borrowers paid off and terminated the 1996 credit agreement (DX 151 at 9). Co-borrowed debt increased from $3.751 billion at the end of 2000 to $5.04 billion at the end of 2001 (Tr. 47; DX 150 at 29, DX 151 at 11; RX 313 at 8). By the end of 2001, the Rigas Entities' allotted share of the co-borrowed debt had increased to approximately $2.45 billion, up from approximately $1.6 billion at year-end 2000 (Tr. 1082; DX 151 at 11; RX 313 at 8).

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[10] Arahova was not a public company because Adelphia owned all shares of its outstanding common stock (Tr. 165). Arahova was required to file a Form 10-K with the Commission as a result of outstanding public debt assumed in an acquisition (Tr. 165; RX 111 at DT 651087).

[11] Arahova Form 10-Q/A, dated August 14, 2001 (official notice).

[12] After the Commission issued the OIP in this matter, Dearlove relinquished his position as CTG's Chief Financial Officer and became CTG's Senior Vice President of Administration (Tr. 1926; CTG Form 8-K, dated October 17, 2005 (official notice)).

At the end of 2001, Adelphia's Class A common stock closed at $31.18 per share (Tr. 96). See http://finance.yahoo.com/q/hp?s.

Post-Enron Fallout: Disclosure of Off-Balance Sheet Liabilities

In January 2002, following the collapse of Enron Corporation, the Commission issued a statement that expressed its views on matters that public companies should consider disclosing in their calendar year 2001 financial statements (Tr. 1128). See Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, 76 SEC Docket 2220 (Jan. 22, 2002). The Commission's statement did not change the law, see id. at 2221, but it provided additional guidance on the disclosure of off-balance sheet obligations (Tr. 1080, 1128).

Shortly after the Commission issued its release, O'Leary told Brown that "things had changed" and that Adelphia would have to disclose more about the co-borrowing agreements than it had previously (Tr. 154-55). Brown agreed (Tr. 155-56).

Adelphia Discloses Its Off-Balance Sheet Obligations

Adelphia released its fourth quarter and year-end 2001 results on March 27, 2002 (Tr. 74-75; DX 175). Its press release disclosed for the first time that the Rigas Entities' co-borrowed debt of more than $2.28 billion was not reflected as debt on Adelphia's publicly disclosed financial statements (Tr. 75; DX 175, Table 3, n.6). On the same day, Adelphia held a conference call with investors and analysts to discuss its fourth quarter and year-end 2001 results (Tr. 75-76, 97). Brown and Timothy Rigas, the Adelphia representatives responsible for answering questions during the conference call, were concerned about the potential reaction to several disclosures, including the disclosure about the extent of the Rigas Entities' co-borrowed debt (Tr. 1084-85). Timothy Rigas stated (DX 176 at 2):

> The managed entities used most of the borrowings under these credit facilities to refinance existing indebtedness, to fund the rebuilding of certain cable systems and to acquire other cable systems. Other proceeds borrowed by these Managed Entities were advanced to Rigas family partnerships, which used those proceeds to buy various securities from Adelphia. The company expects the Managed Entities to repay the borrowings in the ordinary course. The company does not expect that [it will] need to repay the amounts borrowed by Managed Entities.

During the conference call, analysts questioned the Rigas Entities' ability to repay their co-borrowed debt (DX 176). Brown and Timothy Rigas could not explain what assets supported the borrowing, and promised to get back to the analysts (Tr. 80; DX 176 at 14). Within an hour or two after the conference call, Adelphia began to receive several telephone inquiries, demanding more particularity about the debt (Tr. 82).

Adelphia management pressed Deloitte to complete the audit and issue an opinion on its 2001 Financial Statements by the end of March 2002 (Tr. 43-44). Deloitte refused to do so, and the audit continued into April 2002 (Tr. 642-43). As a result, Adelphia failed to meet the filing deadline for its 2001 annual report.

A special committee of Adelphia's board of directors, composed of members of the board who were not Rigas family members, commenced a formal investigation into related-party transactions between Adelphia and the Rigases. This investigation led to the public disclosure of information about the Rigas family's co-borrowing activities, related-party transactions, and involvement in accounting irregularities. In May 2002, the Rigases resigned their positions as officers and directors of Adelphia (DX 151 at 5, DX 152).

Deloitte suspended its auditing work on May 14, 2002 (Tr. 668, 918; DX 151 at 4). Adelphia announced that it expected to restate its financial statements for 1999 and 2000 (DX 150 at 30). Deloitte withdrew the audit reports it had issued with respect to those financial statements (Lesser Report at 6-7; Tr. 1384; DX 150 at 32). Adelphia terminated Deloitte as its outside auditor and retained PricewaterhouseCoopers LLP (PWC) in June 2002 (Tr. 1158; DX 152).

Adelphia's common stock price declined precipitously (Tr. 82; DX 177; RX 194 at 46). On March 26, 2002, the day before the press release and the conference call, Adelphia's Class A common stock had closed at $20.39 per share. See http://finance.yahoo.com/q/hp?s. By June 7, 2002, it closed at $0.30 per share and had been delisted from the NASDAQ National Market (DX 150 at 32, DX 177).

Adelphia and its subsidiaries defaulted under various credit agreements and notes. They filed a voluntary petition to reorganize under Chapter 11 of the Bankruptcy Code on June 25, 2002 (DX 150 at 33, 49). Since that time, Adelphia and its subsidiaries have remained under the protection of the bankruptcy court. They have continued to operate as debtors-in-possession under new management.

### D. Related Litigation

Criminal Prosecutions

Following an investigation by the U.S. Department of Justice, certain members of the Rigas family and other Adelphia officials were indicted on charges including fraud, securities fraud, bank fraud, and conspiracy to commit fraud (DX 150 at 54). Brown and Werth promptly pleaded guilty and cooperated with the prosecution.

In July 2004, a jury found John and Timothy Rigas guilty of conspiracy (one count), bank fraud (two counts), and securities fraud (fifteen counts) (Tr. 87; DX 150 at 54).[13] The jury

[13] There is no evidence that any convictions or guilty pleas related to any matters asserted in, or omitted from, Adelphia's 2000 Financial Statements.

acquitted Michael Rigas of some charges, but could not reach agreement with respect to others. The jury also acquitted Michael Mulcahey, Adelphia's former treasurer, of all charges.

Adelphia and its subsidiaries were never indicted. In April 2005, the Department of Justice, Adelphia, and the Rigases reached a global settlement of all outstanding issues. As described below, the Commission also participated in the global settlement. The Rigas family agreed to forfeit to the United States a substantial portion of its assets. The Department of Justice agreed not to prosecute Adelphia or its subsidiaries. Adelphia agreed to cooperate with the government's investigation and to make a deferred contribution of $715 million in stock and cash to a victims' restitution fund. Payment of the $715 million is not required until Adelphia emerges from bankruptcy. The global settlement agreements were subsequently approved by the U.S. District and Bankruptcy Courts for the Southern District of New York. See United States v. Rigas, 371 F. Supp. 2d 474 (S.D.N.Y.), pet. denied, 409 F.3d 555 (2d Cir. 2005); In re Adelphia Communications Corp., Debtor, 327 B.R. 143 (Bankr. S.D.N.Y. 2005).

In June 2005, the court sentenced John and Timothy Rigas to lengthy prison terms. As part of the global settlement, the Department of Justice did not seek a criminal fine or forfeiture against either defendant. Since July 2005, John and Timothy Rigas have remained free on bail pending appeal. Appellate briefing has been completed, oral argument has been held, and a decision is pending (2d Cir. No. 05-3577-cr.).

The Commission's Civil Action Against Adelphia

On July 24, 2002, the Commission filed a civil injunctive action against Adelphia, four members of the Rigas family, and others. SEC v. Adelphia Communications Corp., No. 02-Civ.-5776 (KW) (S.D.N.Y.). The Commission alleged that the defendants violated the antifraud, periodic reporting, record keeping, and internal controls provisions of the federal securities laws between 1998 and the end of 2001. See Litig. Release No. 17627, 78 SEC Docket 407 (July 24, 2002).

On April 25, 2005, as part of the global settlement, the Commission settled its civil action against Adelphia and the four Rigas defendants. Adelphia and the Rigases were permanently enjoined from violating the antifraud, periodic reporting, record keeping, and internal controls provisions of the federal securities laws (RX 26). The individual Rigas defendants were barred from acting as officers or directors of public companies (RX 26). In return for Adelphia's promise to pay $715 million in stock and cash to the victims' restitution fund, the Commission agreed not to require Adelphia to pay disgorgement or a civil penalty. See Adelphia, 327 B.R. at 158.

The Commission's Actions Against Deloitte

The Commission brought civil and administrative proceedings against Deloitte for violating GAAS in connection with its audit of Adelphia's 2000 Financial Statements.

On April 26, 2005, the Commission filed a settled action for a civil monetary penalty against Deloitte for violating Section 10A(a) of the Exchange Act. SEC v. Deloitte & Touche

LLP, No. 05-Civ.-4119 (PKC) (S.D.N.Y.). Without admitting or denying the allegations in the Commission's complaint, Deloitte agreed to pay a civil penalty of $25 million and disgorgement of $1.00, with the payments to be deposited into a fund to compensate the victims of Adelphia's fraud. See Litig. Release No. 19202, 85 SEC Docket 1272 (Apr. 26, 2005).

In a related administrative proceeding, the Commission censured Deloitte for improper professional conduct under Rule 102(e) of its Rules of Practice.[14] Without admitting or denying the allegations in the OIP, Deloitte agreed to pay an additional $25 million into a fund to compensate the victims of Adelphia's fraud.[15] Deloitte also agreed to undertake certain remedial actions when auditing high-risk clients in the future. See Deloitte & Touche LLP, 85 SEC Docket 1111, 1123-25 (Apr. 26, 2005).

## DISCUSSION OF ACCOUNTING AND AUDITING ISSUES

The substantive allegations in the OIP focus on five matters in Adelphia's 2000 Financial Statements and Deloitte's audit of those five matters: (A) Adelphia's treatment of co-borrowed debt on its balance sheet and in note disclosure; (B) Adelphia's reclassification of debt from its balance sheet to the balance sheets of the Rigas Entities; (C) Adelphia's practice of netting related-party payables and receivables; (D) Adelphia's accounting for direct placements of its Class B common stock; and (E) Adelphia's disclosure of certain related-party transactions in the notes to its financial statements.

GAAS consist of three general standards, three standards of field work, and four standards of reporting. See AICPA, Codification of Statements of Auditing Standards § 150.02 (2000) (AU § ___). The Division alleges that Dearlove violated the second and third general standards, the first and third standards of field work, and the first and third standards of reporting

[14] The OIP alleged, and the Commission found, that Deloitte engaged in repeated instances of unreasonable conduct. Unlike the present proceeding against Dearlove, the OIP did not allege that Deloitte engaged in intentional or knowing conduct, including reckless conduct, that resulted in a violation of applicable professional standards. Nor did the OIP allege that Deloitte engaged in highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which an accountant knew, or should have known, that heightened scrutiny was warranted.

[15] Unlike the settlement in the companion civil proceeding, the Settlement Order in Administrative Proceeding No. 3-11910 did not specify whether Deloitte's $25 million payment represented a civil penalty, disgorgement of ill-gotten gains, interest, or a combination of all three. Of course, financial sanctions are not a permissible form of relief in proceedings brought under Rule 102(e) of the Commission's Rules of Practice. Moreover, payments to FAIR Funds under Section 308(a) of the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7246(a), are not possible in Rule 102(e) proceedings because such proceedings are not "brought by the Commission under the securities laws (as such term is defined in Section 3(a)(47))" of the Exchange Act. Section 308(b) of the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7246(b), is considered below. See infra pp. 71-72.

(Lesser Report at 17-22). The second general standard requires an auditor to maintain an independent mental attitude. The third general standard requires that due professional care be exercised in the performance of the audit and the preparation of the report. The first and third standards of field work require that work is to be adequately planned and assistants, if any, are to be properly supervised; and that sufficient competent evidential matter be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. The first standard of reporting requires the report to state whether the financial statements are presented in accordance with GAAP. The third standard of reporting provides that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

Lesser, the Division's expert accounting witness, opined that Adelphia's 2000 Financial Statements failed to comply with GAAP and that Deloitte's audit, under Dearlove's direction, did not comply with GAAS. In Lesser's judgment, Deloitte should have identified Adelphia's GAAP violations during the audit. If Adelphia then failed to correct the GAAP violations, Dearlove should have either qualified Deloitte's opinion or caused Deloitte to disclaim an opinion or issue an adverse opinion on the financial statements.

Love, the accounting expert for Dearlove, opined that Deloitte's audit complied with GAAS in all material respects. He also opined that Dearlove exercised due professional care and reasonable professional judgment as Deloitte's engagement partner. Finally, Love concluded that GAAP was properly and reasonably applied.

### A. Co-Borrowed Debt

The OIP alleges that Adelphia violated GAAP by failing to include on its 2000 Financial Statements approximately $1.6 billion in debt that was drawn down by the Rigas Entity co-borrowers (OIP ¶¶ II.2, C.16-.19, .21-.22 & nn.1-2). The Division relies on two alternative theories in support of this charge: (1) GAAP required Adelphia to record all the co-borrowed debt—including the debt drawn down by the Rigas Entity co-borrowers—because liability under the credit agreements was joint and several and Adelphia was a primary obligor; and (2) even if the obligations of the Rigas Entity co-borrowers were appropriately viewed as primary obligations of the Rigas Entities and only as contingent liabilities of Adelphia, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (March 1975) (FAS 5), required Adelphia to record the entire $1.6 billion because Adelphia's contingent liability was probable and the amount of loss could be reasonably estimated.

The Co-Borrowers' Perspective

Beginning in 1996, Adelphia and the Rigas Entities had allocated co-borrowed debt among themselves according to which entity received the benefits. In 2000, as in earlier years, Adelphia recorded on its books the amount of debt for which it and its subsidiaries assumed the primary obligation of repayment, and the Rigas Entity co-borrowers recorded on their books the amount of debt for which they assumed the primary repayment obligation. As between Adelphia and the Rigas Entity co-borrowers, Adelphia considered itself and its subsidiaries secondarily—and therefore, contingently—responsible for the debt recorded on the books of the Rigas Entity

co-borrowers. The Rigas Entity co-borrowers considered themselves contingently responsible for the debt recorded on the books of Adelphia and its subsidiaries.

According to Adelphia, the economic reality was that only a single co-borrower was primarily responsible for carrying and repaying each dollar of debt. All other co-borrowers were secondarily—and therefore, contingently—responsible for that dollar of debt, to be called upon only in the event that the primary obligor failed to pay. Adelphia treated each co-borrower as a guarantor of the other co-borrowers' debt, and Deloitte agreed with that characterization (Tr. 458-60, 677, 1929-33). Deloitte also agreed with Adelphia that it was not appropriate to record Rigas Entity debt on Adelphia's consolidated balance sheet (Tr. 195, 351, 537, 942, 1759-61, 1865, 2128, 2136).

The Lenders' Perspective

The banks made their 1999 and 2000 lending decisions on the financial strength of the co-borrowing group as a whole, not on the financial strength of the individual borrowers (Tr. 1277-78). In assessing the co-borrowers' credit worthiness, the 1999 and 2000 lenders considered a variety of factors, such as the borrowing group's cash flow and the liquidation value of the borrowing group's assets (Tr. 1247-51). Once the 1999 and 2000 credit agreements were in place, the lenders did not monitor the individual co-borrowers or the amounts that each had drawn (Tr. 162, 1258-59). In fact, the lenders only received financial statements from the co-borrowing group as a whole (Tr. 441, 624). The lenders understood that the co-borrowers were jointly and severally liable for the debt and, accordingly, that all were liable for whatever debt was drawn, regardless of which co-borrower drew the funds (Tr. 1257-59). In the event of a default, the credit agreements did not specify which co-borrower the lenders should approach first for repayment (Tr. 1265). Instead, the lenders were free to pursue any co-borrower (Tr. 1258-59, 2025).

**(1) The Division's First Theory**

The Terms-of-the-Contract Approach

The OIP alleges that GAAP required Adelphia to record "virtually all" of the co-borrowed debt on its balance sheet because liability under the credit agreements was joint-and-several. The Division contends that each borrower was a primary obligor of all the debt drawn down by the other co-borrowers and that no borrower was a guarantor. Under the Division's theory, the entire co-borrowed debt should have been reflected on each borrower's financial statement as its "direct liability" (OIP ¶ II.C.17). To avoid double counting, each borrower could have simultaneously booked a receivable from each other co-borrower, reflecting offsetting amounts (Division's Reply Memorandum at 7-8) ("Div. Reply Br. ___").[16]

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[16] The Division and Dearlove submitted Pre-Hearing Memoranda of Law, which will be cited as "Div. Prehearing Br. ___" and "Dearlove Prehearing Br. ___," respectively. The Division's Proposed Findings of Fact and Conclusions of Law and the Division's Post-Hearing Memorandum of Law will be cited as "Div. Prop. Find. ___" and "Div. Br. ___," respectively. Dearlove's Proposed Findings of Fact and Conclusions of Law and Dearlove's Post-Hearing

This was the approach that Adelphia's new management took when it filed its overdue 2001, 2002, and 2003 Financial Statements in December 2004 (DX 150). Adelphia's new management concluded that the joint-and-several liability clauses of the co-borrowing agreements required it to place all the Rigas Entity debt on Adelphia's books (Tr. 1167-68, 1179, 1195).[17] This is certainly a legitimate accounting treatment. It is also a very conservative one, which is clearly to the Division's liking. However, the issue for decision is whether the Division has carried its burden of proving that this approach was the only permissible accounting treatment under GAAP. Cf. Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 544 (1979) (recognizing that GAAP tolerate a range of reasonable treatments, leaving the choice among alternatives to management, and holding that management's accounting decisions, even if open to debate, are not necessarily improper, much less intentionally misleading).

Lesser opined that Adelphia had a "genuine liability" for most, but not all, of the co-borrowed debt outstanding as of December 31, 2000 (Tr. 1425-26; Lesser Report at 36-37).[18] To bolster his opinion, Lesser undertook his own analysis of the credit worthiness of the individual co-borrowers. He then attributed his reasoning to the banks. Lesser concluded that the banks were "clearly" relying on Adelphia's financial resources for repayment, and that Adelphia was the "deep pocket" that had "virtual responsibility" for payment of the 2000 loan (Lesser Report at 32).

I reject Lesser's attempt to explain the lenders' thought processes. There is no evidence that Lesser reviewed any lending files or interviewed any lenders. There is no evidence that the banks conducted financial or legal due diligence of the co-borrowers on an entity-by-entity basis. Under the lending agreements' reporting requirements, the banks were only entitled to consolidated financial information from the co-borrowing group as a whole. The co-borrowers,

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Memorandum of Law will be cited as "Dearlove Prop. Find. ___" and "Dearlove Br. ___," respectively.

[17] Scott Macdonald (Macdonald), who became Adelphia's chief accounting officer in March 2003, supervised the preparation of Adelphia's 2001, 2002, and 2003 Financial Statements (Tr. 1157-58, 1160-61). The Division did not identify Macdonald as an expert witness (Tr. 1165). I reject Macdonald's assertion that GAAP required the accounting treatment he chose to apply. I also reject the Division's assumption that accounting decisions made by Adelphia's new management in December 2004 have much relevance here. See infra nn.20, 42, 50.

[18] Lesser limited his opinion to Adelphia's liability for approximately $1.45 billion outstanding under the 1999 and 2000 credit agreements; he did not express an opinion on whether GAAP also required Adelphia to book a liability for approximately $151 million outstanding under the 1996 credit agreement (Tr. 1424-26, 1457). The Division is dissatisfied with this concession by its expert. It attempts to rectify this gap in its proof by claiming that Lesser made a factual mistake in interpreting the 1996 credit agreement (Div. Reply Br. at 8 n.9). I give little weight to the Division's effort to impeach its own expert through the argument of counsel (Tr. 2174-75). If the Division believed it necessary to parse the terms of the 1996 credit agreement, it should have called a witness who could do so.

not the lenders, decided which entity would draw funds under the credit agreements. With the benefit of hindsight, Lesser attempted to attribute to the 1999 and 2000 lenders a level of clairvoyance that the lenders never actually exhibited during their negotiations with the co-borrowers.

Although the Division sponsored a bank representative to discuss the lending process, it never asked the bank representative to endorse Lesser's "deep pocket" theory. In fact, the bank representative made clear that the lenders looked to the co-borrowers as a group, and not only to Adelphia individually, for repayment. Nor did the Division ask the bank representative to confirm that the 1999 and 2000 lending syndicates offered the Rigas Cable Entities access to more credit, at lower interest rates, because Adelphia's subsidiaries were co-borrowers. See supra p. 4.

The Division's contractual analysis approach came undone during the cross-examination of its expert. Lesser acknowledged that no FAS standard specifies how joint-and-several liability arising under a credit agreement should be treated (Tr. 1428-29). He also acknowledged that, during 2001, reputable accounting professionals held different opinions concerning the proper treatment of joint-and-several liability (Tr. 1446-48). Finally, Lesser conceded that the joint-and-several liability provisions of the credit agreements were not sufficient, on their own and without resort to FAS 5, to support his conclusion that most of the co-borrowed debt should have been booked as Adelphia's liability (Tr. 1425-27).

The FAS 125 Approach

The Division next argues that Adelphia and its subsidiaries drew down the entire $3.751 billion in co-borrowed debt and then reassigned approximately $1.6 billion of that amount to the Rigas Cable Entities. Paragraph II.C.22 & n.2 of the OIP contend that Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (June 1996) (FAS 125), foreclosed Adelphia from unilaterally extinguishing such debt. FAS 125 ¶ 16 provides that a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of two conditions is met: (a) the debtor pays the creditor; or (b) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.[19]

The Division's theory got off to a promising start when Brown testified that, as far as he knew, all the borrowing notices to the banks came from Adelphia (Tr. 162). However, Brown quickly explained that he did not want to generalize without looking at each transaction (Tr. 163). The Division could have provided the necessary factual support for this theory by offering all the borrowing notices as exhibits, but it introduced only one such borrowing notice (DX

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[19] FAS 125 was replaced by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Sept. 2000) (FAS 140), effective March 31, 2001. See FAS 140 ¶ 19. The relevant provisions of FAS 125 and FAS 140 are identical.

35).[20] Moreover, it is undisputed that Highland Prestige Georgia, Inc. (Highland Prestige Georgia), a Rigas Entity, drew down $145 million of co-borrowed funds in July 2000 (Tr. 403).

As discussed below, the Division demonstrated that Adelphia's accounting department reclassified approximately $296 million of debt from the books of Adelphia's subsidiaries to the books of the Rigas Entities during 2000. See infra pp. 33-36. In addition, the Division demonstrated that Adelphia wrongfully reduced its debt and increased its equity by approximately $368 million in connection with a direct placement of Class B stock. See infra pp. 40-45. To that extent, the Division has proven that Adelphia and its subsidiaries were primary obligors for the debt and could not extinguish it unless they complied with FAS 125 ¶ 16. These matters each involved material amounts. However, the Division did not show that Adelphia and its subsidiaries drew down $1.6 billion of co-borrowed debt and later transferred it to the books of the Rigas Entity co-borrowers.

The Division's expert never mentioned FAS 125 in his direct written testimony. Rather, he inexplicably referred to FAS 5 (Lesser Report at 29).[21] When asked on cross-examination to identify each of the bases for his opinion, Lesser again did not identify FAS 125 (Tr. 1448).

Lesser's decision not to opine on FAS 125 was not surprising, as that standard does not address whether an enterprise must record or recognize a joint-and-several obligation in the first instance. Instead, it sets forth the requirements for derecognizing or extinguishing a liability that an enterprise has already recognized. See FAS 125 ¶ 16. The issue presented by the Division's first theory is a different one: whether the joint-and-several liability provisions of the credit agreements required Adelphia to recognize all the co-borrowed debt as its primary obligation in the first place. There is authoritative accounting literature that speaks to this question, but the text of FAS 125 does not.[22]

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[20] The Division could only prove this theory by looking at evidence that was available to Deloitte at the time of the audit. It could not look at later-developed evidence, as Lesser attempted to do (Lesser Report at 44, citing DX 150 at 134).

[21] If the entire co-borrowed debt is an actual liability of Adelphia, then FAS 5, which addresses only contingent liabilities, is irrelevant to the GAAP analysis (Tr. 1168; Love Report at 21).

[22] In the absence of authoritative GAAP directly on point, analogous transactions for which there are established accounting principles often shed light on the appropriate accounting treatment (Tr. 1439-40; Love Report at 24). Dearlove contends that AICPA Statement of Position No. 96-1, Environmental Remediation Liabilities (Oct. 10, 1996) (SOP 96-1), constitutes such analogous authority here. SOP 96-1 does not require a reporting enterprise to record the total environmental remediation cost, just because there is joint-and-several liability. Rather, it permits enterprises to allocate their respective shares of joint-and-several environmental remediation liabilities under certain circumstances. Dearlove argues that SOP 96-1 supports the decision of Adelphia and the Rigas Entities to allocate their respective shares of co-borrowed debt in 2000.

There is no evidence that Deloitte specifically addressed SOP 96-1 during the 2000 audit. Dearlove's testimony about his consideration of SOP 96-1 was not credible (Tr. 2128-31).

I conclude that the Division has failed to prove that the joint-and-several liability clauses in the co-borrowing agreements, by themselves, required Adelphia to record all the co-borrowing as its primary obligation. I further conclude that the Division has failed to prove that Adelphia and its subsidiaries drew down every dollar of co-borrowed debt and shifted approximately $1.6 billion of it to the Rigas Entities in violation of FAS 125 ¶ 16.

**(2) The Division's Alternate Theory**

The Division contends that, even if the co-borrowed debt of the Rigas Entities were appropriately viewed as a contingent obligation of Adelphia pursuant to a guarantee, a proper FAS 5 analysis required that the debt be recorded on Adelphia's books because it was probable that Adelphia would have to pay that contingent obligation. The Division further argues that Adelphia should have recorded the full $1.6 billion, and not some lesser amount (Div. Prehearing Br. at 10; Div. Br. at 23-24; Div. Reply Br. at 8).

Dearlove asserts that the Rigas Entity co-borrowers were substantial cable companies with a significant number of subscribers, related-party receivables, operating cash flows, and the ability to service and repay their debt independent of any contribution from Adelphia. He also argues that Deloitte performed a FAS 5 analysis and properly concluded that it was not probable that Adelphia would be required to respond on its guarantee (Dearlove Br. at 80-81).

The Requirements of FAS 5

The relevant parts of FAS 5 set forth the standards of financial accounting and reporting for loss contingencies. FAS 5 defines a loss contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the incurrence of a liability. FAS 5 ¶ 1.

When a loss contingency exists, the likelihood that the future events will confirm the incurrence of a liability can range from "probable" to "reasonably possible" to "remote." FAS 5 ¶ 3. "Probable" means that the future events are "likely" to occur; "reasonably possible" means that the chance of the future events occurring is "more than remote but less than likely"; and "remote" means that the chance of the future events occurring is "slight." Id. Examples of loss contingencies include guarantees of indebtedness of others. FAS 5 ¶ 4(h). The standards for measuring FAS 5 probability are nebulous. Cf. Miller v. Champion Enterprs., Inc., 346 F.3d 660, 687-89 (6th Cir. 2003) (addressing FAS 5 probability).

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Deloitte's audit work papers are silent. In any event, the Division argues that SOP 96-1 requires essentially the same sort of "wherewithal" analysis for joint-and-several environmental remediation liabilities that FAS 5 requires for contingent liabilities. While I agree with the Division, that does not assist the Division's FAS 125 argument.

An estimated loss from a loss contingency must be accrued by a charge to income only if two conditions are met: (1) information available prior to issuance of the financial statements indicates that it is "probable" that a liability had been incurred at the date of the financial statements; and (2) the amount of loss can be "reasonably estimated." FAS 5 ¶ 8.

The purpose of the two conditions in FAS 5 ¶ 8 is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. FAS 5, Appendix C, ¶ 59. The requirement that the loss be reasonably estimable is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of the financial statements. Id. The Financial Accounting Standards Board (FASB) has concluded that disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Id. Further, even losses that are reasonably estimable should not be accrued if it is not probable that a liability has been incurred at the date of an enterprise's financial statements because those losses relate to a future period, rather than the current or a prior period. Id.

If no accrual is made for a loss contingency because one or both of the conditions in FAS 5 ¶ 8 are not met, disclosure of the contingency must be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. FAS 5 ¶ 10. The disclosure must indicate the nature of the contingency and must give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Id. If the range of possible loss is wide, FAS 5 ¶ 8 requires accrual of the amount that is considered a reasonable estimate of the loss. FAS 5, Appendix A, ¶ 39. Paragraph 10 of FAS 5 requires disclosure of the additional exposure to loss if there is a reasonable possibility that such additional loss may have been incurred. Id.

The Division raises two distinct FAS 5 arguments. First, it contends that, if Dearlove did not gather sufficient competent evidence that Adelphia's contingent liability was remote, he should not have signed a report stating that Adelphia's 2000 Financial Statements had been prepared in accordance with GAAP and audited in accordance with GAAS. Second, it contends that Adelphia's financial statements were materially misleading because its contingent liability was probable and the amount of loss was reasonably estimable at $1.6 billion. I conclude that the Division has easily proven its GAAS claim. See infra pp. 26-27. I further conclude that there is not evidence to show that the contingency was "probable" or "reasonably possible," or that $1.6 billion was a reasonable estimate. See infra pp. 27-28.

Wherewithal Needed by the Rigas
Cable Entities at Year-End 2000

FAS 5 required Deloitte to assess the Rigas Cable Entities' wherewithal to pay their own debt (Tr. 458-59, 2155). Lesser focused on the ability of the Rigas Cable Entities eventually to repay the principal amount of their co-borrowed debt (Lesser Report at 37). He did not discuss whether some or all of the co-borrowed debt was likely to be refinanced before any principal was due.

The auditors knew that the co-borrowers were not obligated to repay any principal on the three loans during 2000 or 2001 (Tr. 145, 1272-73, 1768; DX 18 at 31-32, DX 19 at 43). They

also knew the three loans were not in default during 2000 and there was no expectation that they would be in default during 2001 (Tr. 1893, 2153-54).

The record contains two estimates of the interest owed during 2000 on the Rigas Cable Entities' share of co-borrowed debt. Macdonald estimated the interest at $89 million (RX 313 at 9). However, he did not identify the source materials upon which he relied. Lesser estimated the interest at $69.3 million (Lesser Report at 31-32). Lesser's estimate excluded interest on draws by Highland Video Associates, L.P. (Highland Video Associates), the only Rigas Cable Entity to participate in the 1996 credit agreement. His estimate included interest on draws by Highland Prestige Georgia, the only Rigas Cable Entity that was a party to the 2000 credit agreement, and interest on draws by Hilton Head Communications, L.P. (Hilton Head Communications), the only Rigas Cable Entity that was a party to the 1999 credit agreement. Highland Prestige Georgia's share of the 2000 interest payments was approximately $22.3 million (Tr. 1581-82; DX 86.12; Lesser Report at 31-32). Hilton Head Communications' share of the 2000 interest payments was $47 million (Tr. 1581-82; Lesser Report at 31-32). Under Lesser's incomplete estimate, Highland Prestige Georgia and Hilton Head Communications collectively owed $69.3 million in interest payments during 2000.

Based on the present record, I conclude that the Rigas Cable Entities needed wherewithal ranging from approximately $69.3 million to $89 million during 2000 to service the interest on their share of the co-borrowed debt.

Deloitte Gave Only Superficial Consideration to FAS 5

OIP ¶ II.C.19 alleges that Dearlove knew or should have known that Adelphia did not perform a FAS 5 assessment. It further charges that Dearlove took no steps to determine whether the Rigas Entities had the financial wherewithal to repay the co-borrowed debt for which they identified themselves as primary obligors.

The Division failed to prove that Adelphia did not perform its own FAS 5 assessment. Carl Rothenberger (Rothenberger) is an attorney at Buchanan Ingersoll, Adelphia's outside counsel. Late in March 2001, Rothenberger suggested to Werth that Adelphia should consider FAS 5 and discuss it with the auditors (Tr. 1071-72). Werth responded in "fairly resolute" terms that Adelphia's contingent liability exposure was remote (Tr. 1072). Werth could not have announced such a conclusion unless Adelphia had already performed a FAS 5 assessment, or unless he intentionally misled Rothenberger. At the hearing, Werth could not recall performing a FAS 5 analysis or telling Rothenberger that he had done so (Tr. 359-61). The Division has vouched for Werth's credibility as a witness (Div. Prop. Find. ## 12-13). In these circumstances, the Division cannot equate Werth's failure to recollect with "proof" that Adelphia never analyzed FAS 5.

The more important issue is whether Deloitte tested management's representation that Adelphia's contingent liability was remote. Management representations are part of the evidential matter an independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. AU § 333.02.

Deloitte never specifically asked Adelphia management about FAS 5 or about the ability of the Rigas Entities to service and eventually repay the debt for which they considered themselves primary obligors (Tr. 39-40, 456, 2127-28). Like Rothenberger, the auditors knew that Adelphia considered its contingent liability to be remote (Tr. 1886, 1935-36, 2139-40). According to Dearlove, Deloitte considered the wherewithal of the Rigas Entity co-borrowers and Adelphia's contingent liability during the 2000 quarterly reviews (Tr. 1886-87). The auditors also performed a liquidity analysis of the co-borrowers as a group (Tr. 1895-97). However, Deloitte did not prepare any work papers to memorialize its testing procedures.[23]

The co-borrowers executed management representation letters at the conclusion of the audit (RX 13.24-RX 13.27). The relevant letter assured Deloitte that the guarantees for which Adelphia was contingently liable had been properly recorded on its financial statements and that there were no other loss contingencies that FAS 5 required Adelphia to accrue (Tr. 1936; RX 13.24 §§ 14(b), 17(b)). The letters are entitled to little weight here.[24]

At the end of the audit, Caswell and Dearlove spoke for approximately fifteen minutes about FAS 5 (Tr. 462, 1550, 1888-89). They discussed the collective value of the Rigas Entities' cable systems and assets (Tr. 462-63). Caswell and Dearlove also considered the collective holdings of Adelphia stock by Rigases who were officers and directors (Tr. 464). They concluded that there was sufficient value in those assets so that there was only a remote chance that Adelphia would be required to perform on its guarantee (Tr. 459-60, 2164-65). Caswell and Dearlove did not consider the Rigas Entities' receivables from Adelphia (Tr. 617-18). They did not discuss whether the Rigas Entities' cash flows were sufficient to service their obligations for the co-borrowed debt (Tr. 462). Dearlove did not know if Rigas Entities serviced their portion of the co-borrowed debt by using money provided by Adelphia's subsidiaries (Tr. 2143).

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[23] The information contained in work papers constitutes the principal record of the work that an auditor has done and the conclusions he has reached concerning significant matters. AU § 339.01. Work papers serve mainly to provide the principal support for an auditor's report, including his representation regarding observance of the standards of field work, and to aid the auditor in conducting and supervising the audit. AU § 339.02. Work papers should be sufficient to show that the accounting records agree or reconcile with the financial statements or other information reported on and that the applicable standards of field work have been observed. AU § 339.05. However, an auditor is not precluded from supporting his report by other means in addition to work papers. AU § 339.01 n.3.

[24] A management representation letter is one kind of competent evidence, but it is not sufficient in itself to provide an auditor with a reasonable basis for forming an opinion. See Russell Ponce, 54 S.E.C. 804, 821 (2000), aff'd, 345 F.3d 722 (9th Cir. 2003). The management representation letter did not excuse Deloitte from performing the tests required by GAAS. AU §§ 333.02-.03.

Dearlove contends that the engagement team verbally summarized its FAS 5 conclusions for the benefit of Deloitte's concurring and risk review partners.[25] The evidence in support of this claim is unpersuasive.

Caswell recalled a detailed discussion with Biegel about the accounting for co-borrowed debt during the 1999 audit (Tr. 492). He had a second conversation with Biegel during the 2000 audit, but it consisted largely of refreshing Biegel's recollection about the co-borrowing agreements (Tr. 465-66, 492). Caswell could not remember the specifics of the latter conversation, but he believed it included his FAS 5 analysis (Tr. 467, 493-94). Biegel believed he discussed FAS 5 with someone on the 2000 engagement team, but he could not recall the substance of the conversation (Tr. 896). Biegel asserted it was not probable that Adelphia would have to pay the Rigas Entities' portion of the co-borrowed debt, but he could not remember how he came to that conclusion (Tr. 896-97). I have given very little weight to the testimony of Caswell and Biegel on this issue.

Caswell also had a conversation with Lindsey about FAS 5 and the Rigas Entities' ability to repay their share of co-borrowed debt (Tr. 999-1001). Caswell told Lindsey that, based on the subscriber values, he thought the Rigas Entities could repay the debt they had drawn down. I find it more likely that this conversation occurred during the 1999 audit, not the 2000 audit (Tr. 465, 491, 494, 999-1000). There is no evidence that Dearlove spoke to Hofmann, Biegel, or Lindsey about FAS 5 (Tr. 650, 724-25, 2112-15).

Deloitte did not prepare any work papers to memorialize its quarterly or year-end FAS 5 conclusions (Tr. 460, 462; Lesser Report at 30). Dearlove asserted that there was no need to create a work paper to calculate wherewithal because the engagement team concluded that Adelphia's contingent liability was remote (Tr. 1890-91). He offered no explanation for the absence of work papers documenting the contingency analysis itself. Because the issues were complex and had a major impact on the financial statements, the absence of work papers is troubling.

Deloitte's Reliance on the Rigas
Family's Presumed Wealth Was Misplaced

John, Michael, Timothy, and James Rigas collectively owned almost 45 million shares of Adelphia common stock as of December 31, 2000 (Tr. 144, 1486; DX 156 at 8-10 and notes (a)-(c)). Adelphia's Class A common stock was then trading at $51.62 per share (Tr. 96, 1486). See supra p. 5. Although there was no established public market for Adelphia's Class B common stock, the Class B stock was convertible to Class A stock on a one-to-one basis (DX 31 at 33, DX 156 at 9). The auditors multiplied the number of shares the Rigases owned by the price per

[25] Neither GAAP nor GAAS require a concurring review. See Potts v. SEC, 151 F.3d 810, 813 (8th Cir. 1998). However, firms like Deloitte that are members of the AICPA's SEC Practice Section are required as a condition of membership to use concurring reviewers on SEC engagements. See AICPA, SEC Practice Section Reference Manual § 1000.8(f). Neither GAAP nor GAAS require a risk review partner. Only Deloitte's internal auditing standards require a risk reviewer.

Class A share and valued the Rigases' common stock at approximately $2.3 billion. Because this amount far exceeded the Rigas Entities' obligations for servicing their co-borrowed debt, Deloitte considered this as one piece of audit evidence that Adelphia's loss contingency was remote.

The 1999 and 2000 lenders did not evaluate the assets of the Rigas family when they determined the credit worthiness of the co-borrowing group (Tr. 1259, 1278). No part of the Rigas family's assets was pledged as collateral under the 1999 or 2000 co-borrowing agreements (Tr. 48-49, 464-65, 1548). Dearlove understood that the Rigas family was not legally obligated to contribute funds in the event of a default by the co-borrowers (Tr. 1881-92). Nonetheless, he believed that, because the family's personal wealth consisted largely of Adelphia stock, it would be economically impractical for the family to allow the Rigas Entities to default (Tr. 1891-95). Caswell shared this belief (Tr. 618-20).

The auditors failed to gather competent evidence to support their beliefs. Deloitte had no specific knowledge of the Rigases' wealth, collectively or individually (Tr. 619, 658, 2159-60). The auditors never asked the Rigas family for any financial statements (Tr. 2159-60). They never considered whether the Rigas family's assets might already be encumbered (Tr. 658-59). Dearlove merely knew that the Rigases owned a substantial block of Adelphia stock and that the media had portrayed the family as billionaires (Tr. 2159-60). The auditors estimated the value of the Rigases' holdings in Adelphia (including Class B stock) based on the current trading price of Adelphia's Class A stock (Tr. 464). They assumed that the Rigases could convert a large block of Class B stock into Class A stock and dispose of it without depressing the market price of the Class A stock (Tr. 658). Finally, the auditors never considered whether disposing of some or all of Adelphia's Class B stock might trigger the change of control provisions, an event of default under the co-borrowing agreements (Tr. 657-58, 2159-60).

The auditors analyzed the Rigases' stock holdings as a unit (Tr. 1481). The Division challenges this "global analysis" as inappropriate (Tr. 1175, 1480). The auditors never discussed the Rigas family's intention or ability to cover any default by the Rigas Entities with Adelphia management or with the Rigases themselves (Tr. 657, 2157). Dearlove has not shown any competent evidential basis for assuming that every Rigas family member would act in lockstep with every other Rigas family member when deciding whether to buy, hold, or sell Adelphia stock. In these circumstances, I agree with the Division that Deloitte's global analysis was inappropriate.[26]

Deloitte did not test Adelphia's FAS 5 analysis. If Deloitte actually performed a FAS 5 analysis that considered the Rigases' presumed wealth and presumed willingness to act, I conclude that its methodology was superficial and its assumptions were groundless.

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[26] Dearlove defends the global analysis on the grounds that others have used it, or at least considered using it (Tr. 1186, 1189, 1191, 1215, 1277; RX 133; Love Report at 27). Assuming, without deciding, that a global analysis might be appropriate in certain circumstances, I conclude that it was inappropriate here because Deloitte lacked competent evidence of the Rigas stockholders' intent to act in unison.

### Deloitte's Assumptions about the Liquidation Value of the Rigas Entities' Collective Subscriber Assets Were Also Unrealistic

The auditors knew that the Rigas Cable Entities collectively had a total of 193,678 basic cable subscribers as of year-end 2000 (Tr. 1887, 1891, 2146-47; DX 31 at 4). The auditors also knew that cable companies were typically valued on a per-subscriber basis and that, during 2000, cable systems had sold for approximately $5,000 to $6,000 per subscriber (Tr. 462-63, 1887, 2146-47). The auditors multiplied the aggregate number of basic cable subscribers by the value per subscriber and concluded that the Rigas Cable Entity subscriber assets were collectively worth approximately $1 billion (Tr. 2146-47).

The Division challenges the auditors for taking comfort in a scenario that required the Rigas Cable Entities to liquidate themselves merely to satisfy the interest payments on their debt. The Division also challenges Deloitte's valuation per subscriber. The Division demonstrated that lenders typically value such assets more conservatively, such as $3,000 to $5,000 per subscriber, in forced liquidations (Tr. 1253-54). These are legitimate criticisms, but there is no need to consider them at length.

As with the Rigas family's stock holdings, the Division disputes the propriety of Deloitte's global analysis. Dearlove and Caswell simply assumed that Rigas Cable Entities that were not co-borrowers would willingly sell their own subscriber assets to assist Rigas Cable Entity co-borrowers that could not meet their own interest payments. Dearlove did not require his assistants to test this assumption, and he had no competent audit evidence to support it.

### No Audit Procedures Tested the Ability of the Rigas Cable Entities to Service their Debt from Operating Cash Flows or Related-Party Receivables

Deloitte did not consider the cash flows of the Rigas Cable Entities during the 2000 audit (Tr. 1896-97). Nonetheless, Dearlove now contends that the Rigas Cable Entities could have relied on their operating cash flows to service at least some of their debt (Dearlove Br. at 52 & n.196).

The record shows only that the Rigas Cable Entities had "some" cash flow (Tr. 1488, 1896). Highland Prestige Georgia had a cash balance of approximately $217,000 as of December 31, 2000 (DX 86.12). Its operating revenues for 2000 were approximately $16.8 million and its operating cash flow was approximately $7.7 million (DX 86.12; Lesser Report at 31; Div. Prop. Find. # 134). Hilton Head Communications had a cash balance of approximately $577,000 as of December 31, 2000 (DX 86.13). Its operating revenues for 2000 were approximately $38.4 million and its operating cash flow was approximately $22.6 million (DX 86.13; Lesser Report at 32). The record contains very little information about the operating cash flow of Highland Video Associates, the only Rigas Entity that was a party to the 1996 credit agreement. However, Lesser acknowledged that Highland Video Associates generated operating cash flows in excess of its debt payment obligations during 2000 (Tr. 1633).

Dearlove also contends that the Rigas Entity co-borrowers had a significant amount of accounts receivable from related parties, and he asserts that they could have used these receivables to service their co-borrowed debt (Tr. 1894, 1896, 2144, 2148, 2149). The Division correctly observes that Deloitte did not consider related-party receivables as part of a FAS 5 wherewithal analysis during the audit (Tr. 617-18).

In his post-hearing pleadings, Dearlove provides data about the number of basic cable subscribers and valuations per subscriber for the three Rigas Entities that were co-borrowers (Dearlove Br. at 70-71 & nn.247, 249). As with his belated references to operating cash flows, this would have been a reasonable place to start a FAS 5 analysis during the 2000 audit. However, Dearlove cannot demonstrate that Deloitte's audit conclusions were reasonable, based on data that his counsel assembled for the first time in 2006.

Because Deloitte did not consider the operating cash flows, related-party receivables, or non-global basic cable subscriber data during the 2000 audit, Dearlove may not point to them now as proof that Deloitte's FAS 5 analysis complied with GAAS.

## Violations of GAAS

In this proceeding, Dearlove defends Deloitte's FAS 5 analysis by arguing that the Rigas Cable Entities had several options for servicing and repaying their share of the co-borrowed debt (Tr. 1894). Among other things, he asserts that the Rigas family probably could have sold $10 or $20 or $100 million of its stock without losing control of Adelphia and without depressing the market price too much. He also suggests that the Rigas Cable Entities had some operating cash flow, and probably could have sold a few of their subscriber assets or liquidated a few of their related-party receivables without necessarily going out of business. On that basis, he urges me to conclude that the Rigas Cable Entities probably had sufficient wherewithal to meet their obligations during 2000.

Any of these areas would have been a legitimate starting point for a FAS 5 analysis, but Deloitte never tested them during the 2000 audit.[27] An auditor cannot demonstrate compliance with GAAS by showing that an enterprise's financial statements "fortuitously turned out to be accurate or not materially misleading." Cf. Amendment to Rule 102(e) of the Commission's Rules of Practice, 68 SEC Docket 707, 711 (Oct. 26, 1998) (Amendment to Rule 102(e)).

Based on the FAS 5 analysis that Dearlove and Caswell say Deloitte actually performed, I reject these defenses. Deloitte failed to obtain sufficient competent evidential matter to afford a

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[27] The Division did not undertake a comprehensive FAS 5 analysis, either. It merely presented a few operating cash flow figures for two of the three Rigas Entity co-borrowers and then stopped, as if the figures somehow spoke for themselves. Just because Deloitte had an insufficient basis for concluding that Adelphia's contingency was "remote" does not mean that the Division automatically prevails in its claim that Adelphia's contingency was "probable" or even "reasonably possible." I conclude that the Division has not sustained its burden of proving the GAAP violation.

reasonable basis for its opinion that Adelphia's contingent liability was "remote." AU § 326.01. Deloitte also failed to document its audit evidence in the work papers or elsewhere. AU § 339.01. I conclude that Dearlove should not have signed a report stating that the financial statements had been prepared in accordance with GAAP and audited in accordance with GAAS. At a minimum, Dearlove should have caused Deloitte to qualify its audit opinion. AU §§ 431.03, 508.22.

Reasonably Estimating the Maximum Amount
of Adelphia's Contingent Liability at Year-End 2000

The Division contends that the only reasonable estimate of Adelphia's contingent liability was $1.6 billion, and that Adelphia should have recorded that amount on its 2000 Financial Statements (Div. Br. at 25 & n.148; Div. Reply Br. at 12). Lesser opined that Adelphia should have booked $1.45 billion, not $1.6 billion (Tr. 1455-60). See supra n.18. Dearlove considers both of these estimates to be wildly inflated (Dearlove Br. at 38, 80).

The Division does not suggest that all three Rigas Cable Entity co-borrowers lacked the wherewithal to service any of the co-borrowed debt recorded on their own financial statements. Rather, it reasons that any shortfall or any inability to comply with the loan covenants by any one borrower meant that the borrower in question would be in default (Lesser Report at 35). Because the co-borrowing agreements allowed the lenders to accelerate the full amount of the debt and turn immediately to Adelphia for repayment in the event of default, the Division maintains that Adelphia should have booked the entire $1.6 billion.

There is no merit to this argument. First, the lenders did not track borrowings, payments, leverage ratios, or operating cash flows by individual borrowers, but only by the co-borrowers as a group. The lenders did not know if an individual borrower failed to service its share of the debt. They only knew if the co-borrowers as a group failed to pay. The Division has not shown that the lenders had access to the entity-by-entity information on which its theory rests. Second, even if one or more co-borrowed loans was vulnerable to being declared in default because an event of default had occurred, the loans were not actually in default because they had not been called as of the date of the financial statements. Cf. Baron v. Smith, 380 F.3d 49, 56-57 (1st Cir. 2004) (distinguishing between an event of default and an actual default in the bankruptcy context). The Division cannot properly equate an event of default with an actual default, just to meet its burden of proving that Adelphia would probably have to make good on its guarantee.

It is accordingly necessary to consider how much of a shortfall, if any, each Rigas Entity co-borrower had at year-end 2000. The record does not include any contemporaneous estimates. Early in 2002, Brown concluded that the Rigas Entity co-borrowers could not service their debt from their operating cash flows (Tr. 50-52). He estimated the collective shortfall was approximately $63 million as of December 31, 2000 (Tr. 54). In October 2004, Macdonald concluded that the Rigas Entities collectively could service only $58 million of the $89 million for which they considered themselves primarily liable as of December 31, 2000 (RX 313 at 9). Thus, information developed after the issuance of Adelphia's 2000 Financial Statements estimated the range of the Rigas Cable Entities' shortfall as between $31 million and $63 million at year-end 2000.

Neither Brown's nor Macdonald's estimate is wholly satisfactory. The parties did not ask these witnesses to explain their calculations. Moreover, FAS 5 ¶ 8 requires an estimate to be made as of the date of the financial statements, and not with the benefit of the hindsight. Brown's estimate is probably too high because it looked only to operating cash flows to satisfy the shortfalls. Both estimates use a global analysis. But see supra n.26. The weight that may be accorded to Brown's and Macdonald's estimates is limited. Nonetheless, they are useful in capping the reasonable estimate of Adelphia's contingent liability as of year-end 2000. A global shortfall in the range of $31 million to $63 million would involve a material amount, see Ponce, 54 S.E.C. at 819-20 & n.42, but it completely undercuts the Division's claim that Deloitte should have reasonably estimated the amount of loss at $1.6 billion.

FAS 5 ¶ 8 requires that a reasonable estimate be made by looking only to the current or a prior period. Auditors have no obligation under FAS 5 to attempt to quantify a contingent obligation through rough guesses or speculation. See SEC v. Steadman, 967 F.2d 636, 643-45 (D.C. Cir. 1992). Crediting Brown's and Macdonald's evidence; applying FAS 5 ¶¶ 8, 10, and 39; and assuming arguendo that the Division had actually proven that Adelphia's contingent liability was "probable," the record shows that Adelphia should have booked no more than $31 million as its contingent liability, and should have disclosed an estimate of no more than an additional $32 million in a note to its financial statements. In the alternative, assuming arguendo that the Division had actually proven that Adelphia's contingent liability was "reasonably possible," the record shows that Adelphia should have disclosed (but not booked) a contingent liability of no more than $63 million. In either event, the Division has failed to prove that Adelphia should have booked $1.6 billion.

**(3) Deloitte Prods Adelphia to Disclose More About Co-Borrowed Debt, but Dearlove Relents in Violation of His GAAS Obligations**

In the Notes to its 1999 Financial Statements, Adelphia disclosed its guarantee of co-borrowed debt in the following language (RX 6 at 73):

> Certain subsidiaries of Adelphia are co-borrowers with Managed Partnerships under credit facilities for borrowing of up to $1,025,000[,000]. Each of the co-borrowers is liable for all borrowings under the credit agreements, although the lenders have no recourse against Adelphia other than against Adelphia's interest in such subsidiaries.

Deloitte had audited Adelphia's 1999 Financial Statements and concluded that this disclosure complied with GAAP (Tr. 1864). Deloitte had reached the same conclusion about similar disclosure language in prior annual reports (Tr. 125, 1691; RX 4 at 34-35, RX 5 at 65). Nonetheless, Adelphia's entry into a new and larger credit arrangement during 2000 required the auditors to address the disclosure issue anew (Lesser Report at 49-50).

During the 2000 quarterly reviews, Deloitte repeatedly encouraged Adelphia management to disclose the specific dollar amount of Rigas Entity co-borrowings (Tr. 1861-62; DX 32, DX 39, DX 43). Although Deloitte did not realize it at the time, Adelphia management

wanted to avoid public disclosure of these amounts. Adelphia management wanted to keep disclosure of the co-borrowing as light, vague, and meaningless as possible (Tr. 27, 214, 353). As a result, Adelphia management simply ignored Deloitte's first two memoranda (Tr. 194-95, 197, 202, 216, 357-58). After the end of the third quarter, Adelphia did agree to revisit the co-borrowing disclosure when it filed its 2000 annual report (Tr. 694; DX 43). Adelphia management believed that it could gain a tactical advantage over Deloitte by postponing any discussion of the issue until late in the audit process, when there would be pressure to meet the filing deadline (Tr. 198, 202, 214, 216-18).

During February and March 2001, the Deloitte engagement team offered written comments on several drafts of Adelphia's Form 10-K (Tr. 207, 697-708; DX 12-DX 17). On six separate occasions, Hofmann and Caswell urged Adelphia to disclose the amount of the co-borrowed debt that was included in Adelphia's balance sheet and the amount of the co-borrowed debt the Rigas Entities had used (DX 12-DX 17).[28] Werth did not respond to Deloitte's written comments (Tr. 206-17). Through an intermediary, Brown informed the auditors that he did not think the additional disclosure was necessary (Tr. 29-30).

The filing deadline for Adelphia's 2000 Form 10-K was Monday, April 2, 2001, the first business day after March 31, 2001 (Tr. 218). Adelphia management and the Deloitte engagement team had scheduled an exit meeting for Friday, March 30, 2001. At that meeting, the auditors planned to raise several remaining issues, including the note disclosure of co-borrowed debt (Tr. 696, 709, 718, 1860, 1869, 2194-95).

A day or two before the exit meeting, Brown drafted an alternative to the disclosure recommended by Hofmann and Caswell and explained why he thought his alternative was preferable (Tr. 31-32, 718, 1869). Brown proposed adding a phrase explaining that each of the co-borrowers "may borrow up to the entire amount available under the credit facility" (Tr. 452-53, 718-19, 1869). 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 exposure (Tr. 452-53). Caswell agreed to take Brown's language back to the engagement team, but he told Brown that he did not think it would be acceptable (Tr. 29-32).

The night before the exit meeting, Dearlove consulted with Hofmann and Caswell about Brown's proposal (Tr. 455).[29] Caswell could not recall the substance of the conversation (Tr.

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[28] Hofmann also gave Dearlove the last four drafts of the Form 10-K, with the engagement team's handwritten recommendations for additional disclosure of co-borrowed debt (Tr. 701-04; DX 14-DX 17). Adelphia's fourth draft of the Form 10-K, dated March 27, 2001, disclosed that the Rigas Entities had outstanding borrowings of nearly $1.6 billion (DX 15 at 65). This was part of the disclosure that the engagement team had been recommending (Lesser Report at 47). However, in the next draft, dated March 28, 2001, Adelphia eliminated that language (DX 16).

[29] Hofmann testified that he never heard of Brown's proposed disclosure or discussed the matter with Dearlove before the exit meeting (Tr. 720). In light of the contrary testimony of Caswell (Tr. 455), I do not credit this testimony. Caswell's account of the timing of the conversation finds support in Brown's testimony. Brown knew before the exit meeting that Deloitte would

450). There are no work papers that summarize this consultation. Dearlove believed that the engagement team's proposed disclosure was appropriate (Tr. 451). However, Dearlove also told Caswell and Hofmann that he did not know how far the engagement team could push the matter with Adelphia, because Deloitte had concluded in prior audits that less disclosure was satisfactory (Tr. 1864, 1879). Dearlove did not believe that the auditors had any basis to insist on the additional disclosure language they had been proposing (Tr. 1866-67, 1879).

At the exit meeting, Brown gave a persuasive presentation that appeared to Deloitte to have been made in good faith (Tr. 33-36, 718, 793). Brown also told Deloitte that his proposed disclosure language had been discussed with, and approved by, Buchanan Ingersoll (Tr. 719, 721, 1869).[30] Dearlove and Brown spoke about Deloitte's proposed disclosure language, but Dearlove was unable to convince Brown to add it to the notes to Adelphia's 2000 Financial Statements (Tr. 1870). Dearlove then gave the final approval to Brown's alternative disclosure language (Tr. 454). He did not ask Adelphia to obtain a legal opinion from Buchanan Ingersoll about the sufficiency of Brown's proposed disclosure language, nor did he seek Adelphia's permission to speak directly with Buchanan Ingersoll about Brown's alternative (Tr. 36, 455, 721, 1076-77, 2194-96).

There is no evidence that the engagement team brought the controversy over the disclosure language to the attention of Deloitte's concurring and risk review partners. Lindsey, the concurring reviewer, had received only the fourth draft of the Form 10-K, the version that disclosed the amount of the Rigas Entities' co-borrowed debt (Tr. 991-95; DX 15 at 65). He never saw any of the other drafts. Biegel, the risk reviewer, could not recall any discussions or disagreements between Adelphia and the engagement team about the appropriate disclosure of

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acquiesce in his proposed disclosure (Tr. 33-34). In any event, Hofmann believed that Brown had raised points that he had not previously considered, and he concluded that Brown's alternative language made sense (Tr. 719-20).

[30] Adelphia management approached Buchanan Ingersoll as a result of its discussions with Deloitte about disclosure (Tr. 1095). Rothenberger was the Buchanan Ingersoll attorney most closely involved in reviewing the proposed disclosure language in Adelphia's 2000 Form 10-K. In a March 29, 2001, e-mail message to Brown and Werth, Rothenberger recommended additional language to clarify that Adelphia's balance sheet did not include any managed entity borrowings (Tr. 1069; RX 48). In a follow-up e-mail on March 31, 2001, Rothenberger asked Adelphia management to advise him why the latest draft Form 10-K did not include either the additional language he had recommended to Brown on March 29 or the language Brown's assistant discussed with him on March 30 (Tr. 1073-75; RX 49). Adelphia management told Rothenberger that the additional disclosure he had recommended was unnecessary (Tr. 1068, 1072).

Rothenberger attempted to explain that Buchanan Ingersoll had merely provided ideas to Adelphia, but that final responsibility for the wording of the note rested with Adelphia and Deloitte (Tr. 1076-77). George Cass (Cass), his law partner, made a similar point (Tr. 2027-28). I have given limited weight to this testimony. This issue is the subject of separate litigation and it does not change the outcome of this proceeding.

co-borrowed debt (Tr. 899-900). Although Dearlove told Hofmann and Caswell to run the final disclosure language changes past Lindsey and Biegel, he did not contact Lindsey or Biegel directly to ensure that they understood the changes to the disclosure language (Tr. 1868-71, 2110-13).

Dearlove argues that the engagement team had pushed for more disclosure. It succeeded in getting some, and the fact that it did not get everything it sought should not be considered evidence of a GAAP violation or a GAAS failure.

I credit Werth's testimony that Adelphia management hoped to gain a tactical advantage over Deloitte by postponing until the last minute any substantive discussion of the note disclosure. I reject the Division's argument that Dearlove did not discuss Brown's proposal with Caswell or Hoffman before the exit meeting. See supra n.29. I do not credit Dearlove's assertion that the disclosure language was a minor point in the context of the entire audit (Tr. 1880). The quarterly review follow-up memoranda and the auditors' handwritten comments on six drafts of the Form 10-K persuade me otherwise. Nor do I credit Dearlove's claim that the auditors were merely taking disclosure language that was already GAAP-compliant and making it even better. Finally, I do not accept Dearlove's explanation that the auditors were in a weak bargaining position because they considered the disclosure language from Adelphia's 1999 Form 10-K to be GAAP-compliant.

I accept Dearlove's testimony that he overruled the engagement team's recommendation because he was persuaded that Brown's language was preferable. However, Dearlove did not understand, and did not ask, why Brown opposed full disclosure of the Rigas Entity debt information (Tr. 2197-98). Dearlove gave too much weight to the conclusions of Deloitte's prior audits. Those prior audit conclusions were not competent evidential matter on which he could properly rely (Lesser Report at 49-50). Brown's claim that Buchanan Ingersoll had endorsed his disclosure language was false, a fact that Dearlove could have confirmed, but did not. Dearlove never sought advice from Deloitte's concurring and risk review partners, or Deloitte's national office about applying GAAP's disclosure requirements to the circumstances before him. I conclude that Dearlove disregarded his GAAS obligations to obtain competent evidential matter to support his conclusions, to employ professional skepticism in analyzing the issue, and to render an unqualified audit opinion only on financial statements and note disclosure that complied with GAAP.

**(4) Adelphia's Disclosure of Co-Borrowed Debt Violated GAAP**

If an issuer guarantees the indebtedness of others, GAAP requires disclosure in the footnotes to the financial statements of the "nature and amount" of the guarantee. FAS 5 ¶ 12. The disclosure must be made even if the likelihood of being required to pay the guaranteed debt is remote (Tr. 458, 2178-81). Id.

Note 4 to Adelphia's 2000 Financial Statements described Adelphia's guarantee of the Rigas Entities' share of the $3.75 billion of co-borrowed debt in the following language (DX 31 at 74):

> Certain subsidiaries of Adelphia are co-borrowers with Managed Entities under credit facilities for borrowings of up to $3,751,250[,000]. Each of the co-borrowers 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.

The OIP asserts that this disclosure failed to conform to GAAP and was misleading (OIP ¶¶ II.C.16, .19 & n.1).

The Division maintains that the Note did not properly disclose the "amount" of the guarantee.[31] It contends that the Note should have disclosed the Rigas Entities' aggregate co-borrowings of approximately $1.6 billion as of December 31, 2000. The Division argues that the Note was misleading because it did not break out the specific amounts that had been borrowed by Adelphia's subsidiaries (an actual liability of Adelphia) and the specific amounts that had been borrowed by the Rigas Entities (a contingent liability of Adelphia). The Note did not distinguish for the reader what had actually been drawn down and reflected in Adelphia's balance sheet line item "Subsidiary Debt," and what had not.

Dearlove responds that the co-borrowing disclosure was not a point-in-time balance sheet item and should not be viewed as one (Tr. 2201-03). Rather, Dearlove characterizes it as a description of the nature and amount of a guarantee, which was not part of the balance sheet. Dearlove contends that the amount owed as of December 31, 2000, might not remain the same through the life of the agreements and that disclosure of the amount of the guarantee at a given point-in-time would be less informative than disclosure of the maximum amount of the guarantee. I reject this argument. Adelphia could easily have added language to the Note to disclose both points.

Dearlove also contends that authoritative accounting literature issued during 2002 demonstrates that the relevant accounting principles were far from settled at the time of the audit (Dearlove Br. at 84-85, 87-88). See FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (November 2002) (FIN 45).[32] Paragraph 13 of FIN 45 provides that a guarantor "shall disclose . . . even if the likelihood of the guarantor's having to make any payments under the

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[31] In its initial post-hearing pleadings, the Division did not argue that Adelphia's Note failed adequately to describe the "nature" of the guarantee (Div. Prop. Find. ## 90-94, Div. Br. at 22). Dearlove contended that the Division has conceded that disclosure of the nature of the guarantee was satisfactory (Div. Br. at 22; Dearlove Br. at 83 n.292). The Division then attempted to challenge the disclosure about the nature of the guarantee (Div. Reply Br. at 4 n.3). I decline to consider the Division's belated argument, because doing so would be fundamentally unfair to Dearlove.

[32] The disclosure provisions of FIN 45 became effective for financial reporting periods ending after December 15, 2002.

guarantee is remote . . . (b) [t]he maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee."

Adelphia concluded that the disclosure of a guarantee that was most relevant to a reader was the maximum potential amount of the guarantee, rather than the particular amount guaranteed at a given point in time. Dearlove reads FIN 45 ¶ 13(b) as supporting that conclusion. I reject this contention, as well. FIN 45 ¶ 13 does not purport to prescribe what is most relevant to a reader, nor does it make any comparison between the potential amount of a guarantee and the amount guaranteed at any particular point in time (Lesser Report at 47).

I agree with the Division that Adelphia was not the guarantor of its own debt. As a result, the crux of the disclosure should have been the guaranteed portion of the co-borrowed debt—the amount that was not recorded on Adelphia's balance sheet, but that Adelphia would be liable for paying if the Rigas Entities could not pay (Tr. 1504-06). FIN 45 ¶ 13 did not alter FAS 5 ¶ 12 in any respect relevant to Adelphia's obligation to disclose the $1.6 billion it had guaranteed for the Rigas Entities.

I conclude that Adelphia's note disclosure of co-borrowed debt failed to conform to FAS 5 ¶ 12. It was materially misleading because it omitted disclosure of Adelphia's $1.6 billion guarantee. If management omits from the financial statements, including the accompanying notes, information that is required by GAAP, the auditor should express a qualified or an adverse opinion and should provide the information in his report, if practicable. AU § 431.03. A reader may assume that informative disclosures in the financial statements are reasonably adequate unless otherwise stated in the auditor's report. AU § 431.01. I conclude that Dearlove violated AU §§ 431.01, 431.03.

**B. Debt Reclassifications**

The Allegations in the OIP

The OIP charges that Adelphia reclassified debt from its books to those of the Rigas Entities without justification, in violation of FAS 125 (OIP ¶¶ II.C.21-.22). It also alleges that Dearlove and the Deloitte engagement team improperly failed to challenge this activity (OIP ¶ II.C.37).

As previously described, cash was received into the centralized treasury system and disbursements were made therefrom. Adelphia managed the accounting for the Rigas Entities, including the payment of their bills. Brown initiated the practice of re-allocating debt among Adelphia and Rigas Entity cost centers on a quarterly basis during 1999 (Tr. 58). He originally intended the process to account for the payment of expenses Adelphia had made during a given quarter on behalf of the Rigas Entities (Tr. 59-60, 156-57). Werth supervised the reclassification process, mostly under Brown's direction (Tr. 59, 157-58, 267, 269, 394-95). Adelphia management began to abuse the process when the Rigases purchased Adelphia securities with co-borrowed funds (Tr. 58, 60, 159-61, 268, 406-07).

Three Challenged Journal Entries During 2000

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 Rigas Entities in exchange for accounts payable in the amount of debt transferred.[33]

After the end of the second quarter of 2000, Adelphia's accounting department transferred the reporting of $36 million of debt from the books of UCA Corporation (UCA), an Adelphia subsidiary, to the books of Hilton Head Communications, a Rigas Cable Entity (Tr. 285-87; DX 118, DX 221). The transaction took place on July 14, 2000, and involved a post-closing journal entry that was retroactive to June 30, 2000 (Tr. 286; DX 118).

After the end of the third quarter of 2000, Adelphia's accounting department transferred the reporting of approximately $222 million of debt from the books of Century Cable Holdings, LLC (Century Cable Holdings), an Adelphia subsidiary, to the books of Highland Prestige Georgia, a Rigas Cable Entity (Tr. 271-75, 287; DX 132, DX 221). The transfer occurred on November 3, 2000, and involved a post-closing journal entry that was retroactive to September 30, 2000 (Tr. 275; DX 132).

After the end of the fourth quarter of 2000, Adelphia's accounting department transferred the reporting of more than $38 million from the books of Century Cable Holdings to the books of Highland Prestige Georgia (Tr. 275-81, 287; DX 135, DX 221). The transfer occurred on February 17, 2001, and involved a post-closing journal entry that was retroactive to December 31, 2000 (Tr. 278-79; DX 135).

Deloitte Never Audited the Three Journal Entries

When planning the audit, Deloitte had identified Rigas control of both Adelphia and the Rigas Entities as posing a special risk (Tr. 2238; DX 81, DX 86.1). Dearlove believed it was important to know whose debt was whose, as between Adelphia and the Rigas Entities (Tr. 2234-35). Nonetheless, Dearlove did not know the specific steps the engagement team employed to audit debt (Tr. 2235-36).

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[33] The OIP implies that every dollar of reclassified debt was co-borrowed debt (OIP ¶ II.C.21(i)). The parties assume this to be true (Div. Prop. Find. ## 186-87, 207; Div. Br. at 15, 36; Dearlove Br. at 3, 7, 112, 122, 128-29). To be sure, the entities that reclassified debt were parties to the co-borrowing agreements. However, apart from one rambling and unpersuasive explanation by Brown (Tr. 159-60), I find no record support for the assumption that the auditors should have known that the reclassified debt was co-borrowed debt. The Division never traced the reclassified debt to its origin. It was just as improper for Adelphia to transfer ordinary debt as it would have been to transfer co-borrowed debt. However, the Division's case for adding $1.6 billion to Adelphia's balance sheet would have been stronger if the Division had shown that the reclassified debt was co-borrowed debt. See supra pp. 14-19.

There is no evidence that Dearlove knew about these journal entries. Brown did not recall discussing the debt reclassifications with Deloitte (Tr. 59, 61). Werth recalled "dialogue" with the auditors on the subject (Tr. 269). However, he could not remember with whom he spoke or what he said (Tr. 270, 394-95). Caswell and Hoffman were not aware of these three transfers during the audit (Tr. 467, 621, 736-37, 803-04).

The Reclassifications Violated GAAP
and the Audit Violated GAAS

The OIP raises two distinct allegations about the debt reclassifications: (1) they involved sham journal entries that had no rational purpose, other than to reduce the level of debt that Adelphia reported in its public filings; and (2) they violated FAS 125 ¶ 16, which provides that a debtor shall derecognize a liability if and only if it has been properly extinguished.

The Division's expert witness did not opine on the propriety of these journal entries and he made no assertion that they violated FAS 125. Nonetheless, the sham nature of the December 31, 2000, reclassification is plain from the face of the supporting documents. The Division demonstrated that the total amount of related-party receivables owed by all the Rigas Entities as of December 31, 2000, was $38,391,685.92, the precise amount of debt transferred to Highland Prestige Georgia as of that date (Tr. 283-85; DX 135, DX 221). At the time, Highland Prestige Georgia owed no outstanding receivables to Adelphia; instead, Adelphia owed Highland Prestige Georgia more than $212 million (DX 135). I infer that, in this instance, the shift of debt to Highland Prestige Georgia did not correlate to that entity's receivables, and that Adelphia reclassified the amount of debt that was necessary to extinguish all the related-party receivables owed to it on that date. The weight of the evidence fails to demonstrate that the other two debt reclassifications involved sham journal entries.[34]

However, all three debt reclassifications violated FAS 125 ¶ 16. The computerized general ledger system shared by Adelphia, its subsidiaries, and the Rigas Entities separately recorded the cash balances of each individual entity. Neither Brown nor Werth offered a cogent explanation of why Adelphia subsidiaries received funds that were intended to benefit the Rigas Entities. Nor was there a satisfactory explanation as to why Adelphia's subsidiaries needed to make intra-quarter payments on behalf of the Rigas Entities (Tr. 159). Once Adelphia's subsidiaries had posted this debt to their books, they became primary obligors for the amounts posted. At that juncture, FAS 125 applied. The Adelphia subsidiaries could not properly remove the debt from their books without first satisfying the criteria of FAS 125 ¶ 16. In the absence of evidence that the Adelphia subsidiaries repaid the debt during the relevant reporting periods, or evidence that a creditor had released Adelphia from its liability for repayment, Adelphia could not unilaterally extinguish the debt by shifting the reporting to the Rigas Entities. Adelphia's attempt to do so violated GAAP. Its financial statements were materially misleading.

[34] The numerous false journal entries, including the reclassifications of debt, are the only transactions specifically identified in the OIP to support the charge that Adelphia lacked an adequate system of internal accounting controls (OIP ¶ II.C.42). See infra pp. 55-57.

Dearlove has offered no good reason why Deloitte failed to audit these three related-party transactions. The auditor with final responsibility for the engagement is responsible for assigning tasks to and supervising assistants. AU § 230.06. Dearlove cannot satisfy his duty to supervise by stating that his subordinates did not bring these matters to his attention. AU § 311.11. The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. AU § 311.13. Post-closing journal entries of this magnitude were significant enough to require the auditors to confront management and request an explanation. The auditors should have documented management's explanation in the work papers, and then conducted additional testing to verify management's assertions.

I conclude that Dearlove violated his GAAS obligations to supervise, AU §§ 230.06, 311.11, 311.13, to exercise due professional care, AU § 230.01, to obtain sufficient competent evidential matter, AU § 326.01, to exercise professional skepticism as to large and unusual transactions occurring at year-end, AU §§ 230.07, 312.17, and to obtain satisfactory evidence of the purpose, nature, and extent of these related-party transactions and their effect on Adelphia's financial statements, AU § 334.09.

### C. Netting of Related-Party Transactions

For several years, Adelphia had netted, or offset, related-party payables and related-party receivables on its consolidated balance sheet (Tr. 57, 111-12, 392, 903, 1680, 1682; RX 4 at 46, RX 5 at 44, RX 6 at 57). Consistent with this longstanding practice, Adelphia presented a line item of $3,071,000 on its consolidated balance sheet as of December 31, 2000, called "Related Party Receivables-Net" (Tr. 55, 117, 467-68; DX 31 at 57).

The OIP alleges that a Commission regulation and GAAP both require that related-party receivables and payables be reported on a gross, rather than net, basis (OIP ¶¶ II.C.24-.26). It also charges that Deloitte violated GAAS by failing to perform the necessary audit procedures and then permitting Adelphia to present its related-party payables and receivables on a net basis (OIP ¶¶ II.C.27-.29).[35]

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[35] The OIP further contends that Adelphia had gross related-party receivables of $1.351 billion and gross related-party payables of $1.348 billion as of December 31, 2000 (OIP ¶ II.C.29). The testimony demonstrates that Adelphia's gross related-party receivables and its gross related-party payables exceeded the reported net figure by a substantial amount and was "into the billions of dollars" (Tr. 56, 219). I decline to rely on the testimony of Carol Savage (Savage) or DX 230 to sustain this aspect of the OIP. Reliance on that evidence would be unfairly prejudicial to Dearlove. See infra n.54.

Finally, the OIP asserts that netting was a fraudulent device that Adelphia used to conceal its liabilities and obscure the magnitude of its self-dealing (OIP ¶¶ II.C.24, .27). As to Adelphia's management, these charges find support in the record (Tr. 55-56, 114-16, 221). Adelphia itself was never indicted for any criminal offenses. See supra p. 12. The assertions add nothing to the Division's case. Adelphia is charged with violating Exchange Act provisions and

The Requirements of Regulation S-X and GAAP

The Commission has prescribed the form, content, and requirements for financial statements that must be filed as a part of annual reports under Section 13 of the Exchange Act. See Form and Content of and Requirements for Financial Statements, 17 C.F.R. § 210 (Regulation S-X). Rule 5-02 of Regulation S-X, 17 C.F.R. § 210.5-02, identifies the line items and additional disclosures that should appear on the face of the balance sheets or related notes filed for commercial companies, such as Adelphia.

Under Regulation S-X, accounts and notes receivable from related parties must appear on the face of the balance sheet or related notes as separately stated amounts. See Rule 5-02.3(a)(2) of Regulation S-X. Accounts and notes payable to related parties must also appear on the balance sheet as separately stated amounts. See Rule 5-02.19(a)(5) of Regulation S-X. In addition, if the amounts due are not current, then Regulation S-X requires separate disclosure of "indebtedness of related parties-not current," see Rule 5-02.11 of Regulation S-X, and "indebtedness to related parties-non current," see Rule 5-02.23 of Regulation S-X.

For Commission registrants, the Rules under Regulation S-X have an authority similar to the highest level GAAP pronouncements. AU § 411.10 n.3.

Paragraph 7.1 of Accounting Principles Board Opinion No. 10 (APB Opinion 10), Omnibus Opinion—1966, states that "[i]t 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."

Paragraph 5 of FASB Interpretation 39, Offsetting of Amounts Related to Certain Contracts (March 1992) (FIN 39), defines a right of setoff and specifies the conditions that must be met to permit offsetting. Under Paragraph 5 of FIN 39, a right of setoff is "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." A right of setoff exists only when four conditions are met (emphasis in original):

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 of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount (Tr. 1531). See FIN 39 ¶ 5. Generally, debts may be set off if they exist between mutual debtors acting in their capacity as both debtor and creditor. See FIN 39 ¶ 6.

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regulations that do not require a showing of scienter. Alleging that Adelphia (or its officers) acted with a corrupt motive is superfluous for these purposes.

FIN 39 is authoritative GAAP (Tr. 1418). AU § 411.10(a). It has been effective for financial statements issued for periods beginning after December 15, 1993. See FIN 39 ¶ 11. Accordingly, Adelphia's practice of netting during the 1980s or early 1990s (before the effective date of FIN 39) is not relevant here.

Deloitte's 2000 Quarterly Reviews
and Its 2000 Audit of Netting

As discussed above, Deloitte identified related-party transactions as a specific risk of the 2000 audit (DX 81; RX 127, tab 3 at 217-19). In addition, Dearlove understood that Adelphia was trying to reduce or eliminate its affiliate receivables to avoid negative reaction by lenders and securities analysts (Tr. 2213-14).

Deloitte reviewed Adelphia's related-party balances on a quarterly basis during 2000 (Tr. 1948; RX 13.61, RX 13.62). It documented the fluctuation of related-party balances from quarter to quarter and summarized management's explanation for the fluctuation in its quarterly review analysis (Tr. 1949; RX 13.61, RX 13.62). Adelphia management expressed its concern to Deloitte about the growing net balance during the second quarter, and indicated that it intended to reduce that balance by drawing funds from a co-borrowed credit facility (Tr. 1950, 2213-15). Dearlove could not explain what the engagement team did to test management's explanation after the draws had been made (Tr. 2219-20).

During the 2000 audit, Deloitte also reviewed the application controls of the general ledger system employed by the Adelphia consolidated entities and the Rigas Entities (Tr. 1945-46; DX 86.16). Deloitte concluded that net indebtedness was fully determinable under Adelphia's system (Tr. 1945-46).

Adelphia's Net Presentation Violated
Regulation S-X and GAAP

Adelphia's 2000 Financial Statements netted related-party transactions "very globally" and did not attempt to match them on an entity-by-entity basis (Tr. 220-21). The Division contends that this presentation failed to satisfy the first condition of FIN 39 ¶ 5 because multiple Adelphia entities were offsetting against multiple Rigas Entities. In the Division's view, FIN 39 ¶ 5 permits offsetting only if there are two parties with mutual obligations, not more than two parties whose individual obligations do not match (Tr. 1531, 1606-08, 1610; FIN 39 ¶ 43).

Dearlove interprets the first condition of FIN 39 ¶ 5 as prohibiting only unilateral offsetting. In Biegel's and Dearlove's view, FIN 39 ¶ 5 requires at least two entities for the requirement of mutuality to be satisfied, but it does not prohibit more than two entities from offsetting (Tr. 903-04, 1703-04, 2230). As an alternative position, Dearlove contends that corporate and partnership distinctions among the various netting entities should be disregarded. In his view, Adelphia and its subsidiaries should be deemed to be one party and the Rigas Entities should be deemed a second party because the private entities were all owned by the Rigas family and managed by Adelphia (Tr. 1536-37, 1776, 2224-25, 2230). In the judgment of Dearlove and Chester Hobert (Hobert), Lindsey's predecessor as concurring reviewer, the

common control of both sides of the transactions should be an overriding consideration (Tr. 1684-85, 1702-07, 1775-76). This is little more than an effort to recycle the "global analysis" that Dearlove embraced with respect to the Rigas family's collective wealth and the Rigas Cable Entities' collective subscriber assets. See supra pp. 24-25. It is no more persuasive here.

The Division reads the first condition of FIN 39 ¶ 5 in a precise and limited manner, while Dearlove interprets it in a more expansive fashion. The Division has the stronger argument. First, FIN 39 represents an exception to a general rule, as expressed in APB Opinion 10. As a matter of construction, such an exception should be applied narrowly, and not as a device to swallow the general rule. Cf. Staff Accounting Bulletin No. 92, 54 SEC Docket 864, 865 (June 8, 1993) ("The guidance in [FIN 39] indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than previously may have been the practice."). Second, the language in the first condition of FIN 39 ¶ 5 is unambiguous and does not require analysis. Dearlove's claim that the italicized word "two" means "any number larger than one" is frivolous. The only witnesses to embrace that interpretation were current or former Deloitte partners (Biegel, Hobert, and Dearlove) whose self-interest in defending the thoroughness of Deloitte's audits is manifest. Even Dearlove's own expert did not endorse this strained reading of the first condition in FIN 39. Finally, there is no evidence that every Rigas Entity was owned by the same Rigas family members in the same proportion.

I conclude that Adelphia's practice of netting related-party transactions on its 2000 Financial Statements violated both Commission Regulation S-X and GAAP.[36] As a result, the financial statements were materially misleading.

Deloitte's Audit of Adelphia's
Net Presentation Violated GAAS

As engagement partner, Dearlove was responsible for determining whether Adelphia's netting of related-party transactions was consistent with GAAP (Tr. 1005). Even though related-party transactions were considered to be an audit risk in connection with the 2000 Financial Statements, Deloitte merely relied on previous conclusions from its audit of Adelphia's 1999 Financial Statements (Lesser Report at 55).[37]

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[36] The OIP also alleges that no agreements existed that established any legal right by Adelphia to set off amounts owed to it by the Rigas Entities or the individual Rigases (OIP ¶ II.C.27) (emphasis added). However, under FIN 39, written agreements are not required for rights of offset to be enforceable at law (Tr. 486, 578, 903, 1534-36). See FIN 39 ¶ 47 (right of setoff may be enforceable at law as part of normal business practice). Adelphia's failure to satisfy the first condition of FIN 39 ¶ 5 is dispositive here. As a result, there is no need to consider whether Adelphia also failed to satisfy any of the other three conditions in FIN 39 ¶ 5.

[37] Brown testified that someone from Deloitte told him during the 2000 audit that netting related party transactions was improper (Tr. 56-57, 116-17). Brown responded that Adelphia had always presented its related-party receivables in that fashion and that he saw no reason to change (Tr. 57, 117). According to Brown, Deloitte then acquiesced (Tr. 57). I believe that Brown was incorrect as to the timing—the conversation in question occurred during 2000, but it related to

There is no evidence in Deloitte's work papers to confirm that the obligations between the offsetting parties were mutual ones (Lesser Report at 57). In fact, there are no work papers at all on the netting issue. Because alternative support is also lacking, I conclude that Dearlove violated AU §§ 339.01-.02.

Dearlove was "generally aware" of the GAAP concerning netting and understood the concepts of FIN 39 (Tr. 2229). He did not know if he "specifically" considered FIN 39 during the audit (Tr. 2229). He also acknowledged that FIN 39 was not a provision he used very often (Tr. 2229). Dearlove did not discuss netting or FIN 39 with Adelphia management, the other members of the engagement team, or Deloitte's national office (Tr. 221-22, 468, 486, 518, 901-02, 1004-05, 2210, 2230-31). I conclude that Dearlove failed to supervise the engagement team, as required by AU §§ 230.06, 311.11, 311.13. Finally, I conclude that Deloitte lacked sufficient competent evidential matter to afford a reasonable basis for its opinion that Adelphia's netting of related-party transactions complied with GAAP. See AU § 326.01.

**D. Direct Placements**

As previously discussed, the change of control provisions of the co-borrowing agreements required the Rigas family to maintain certain levels of majority ownership of Adelphia's common stock. See supra p. 5. Whenever Adelphia raised capital by issuing Class A shares to the public, the Rigases arranged for Adelphia to make a direct placement of Class B shares, so that their voting interests and ownership would not be diluted. See supra p. 3.

The Rigases closed on two such direct placements during 2000, acquiring approximately 8.4 million shares of Adelphia Class B common stock (Tr. 740; DX 31 at 48-49, 82). The January 2000 transaction involved the purchase of $368 million in Adelphia stock by Highland 2000 L.P. (Highland 2000), a Rigas Entity partnership that was not a co-borrower. The July 2000 transaction involved the purchase of another $145 million in Adelphia Class B common stock by Highland 2000.

The Rigases financed both transactions with co-borrowed funds for which Adelphia was jointly and severally liable. Under the Division's theory, Adelphia essentially borrowed money from itself to pay for the Rigas family's new shares of Class B stock. The OIP alleges that Adelphia wrongly recorded the transactions as stock purchases when, in fact, they were only stock subscriptions. By recording the transactions as stock purchases, Adelphia improperly reduced its debt and increased its equity (OIP ¶¶ II.C.21(ii), .32). The OIP also alleges that Dearlove failed to examine these related-party transactions to determine their effect on Adelphia's financial statements (OIP ¶ II.C.39).

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the audit of Adelphia's 1999 Financial Statements. In all other respects, I credit this aspect of Brown's testimony.

## What GAAP Require

Emerging Issues Task Force Consensus No. 85-1, Classifying Notes Received for Capital Stock (1985) (EITF 85-1), provides that, when an enterprise receives a note, rather than cash, for the sale of capital stock, the enterprise should generally report the note receivable as a reduction of shareholders' equity and not as an asset. The Task Force concluded that reporting the note as an asset is generally not appropriate, except in very limited circumstances where there is substantial evidence of ability and intent to pay within a reasonably short period of time. The Task Force confirmed that the predominant practice is to offset the note and stock in the equity section of the balance sheet. A note may be recorded as an asset if collected in cash prior to issuance of the financial statements.

EITF consensus positions are in the third level of the GAAP hierarchy. See AU § 411.10(c). They represent the consensus position of the best thinking of the accounting profession on areas for which there are no specific standards. AU § 411.10 n.3. The purpose of EITF 85-1 is to ensure that an enterprise receives actual and fairly valued consideration for issuing new equity, particularly to insiders and related parties.

The Commission requires public companies to show on the face of their balance sheets the dollar amount of any common shares subscribed but unissued, and to show subscriptions receivable as a deduction from shareholders' equity. See Rule 5-02.30 of Regulation S-X, 17 C.F.R. § 210.5-02.30.

## January 2000 Direct Placement

In January 2000, the co-borrowers collectively drew down $368 million under the 1999 credit agreement (DX 35). At the request of the co-borrowers, the lenders wired the funds to the account of UCA, an Adelphia subsidiary, where it was recorded as a note payable (Tr. 249; DX 35). Adelphia later claimed that this was a posting error. When the purported error was discovered, Adelphia's accounting department transferred the $368 million draw (the recordation of debt) from UCA to Hilton Head Communications, a Rigas Entity co-borrower, and created a corresponding note payable to Hilton Head Communications on UCA's books (Tr. 249-50, 376, 1958-60; DX 101, DX 102, DX 221B/DX 227B). The entries were meant to show that the borrowing was Hilton Head Communications' primary responsibility, and UCA owed it $368 million for the "miswired" cash. The document authorizing these journal entries describes the transaction as the correction of a "misposted wire" (DX 163 at 29728). Adelphia did not transfer the cash to Hilton Head Communications or to any other Rigas Entity.[38]

Adelphia issued shares of Class B common stock to Highland Holdings, a Rigas Entity that was not a co-borrower (Tr. 250, 1958-60; DX 221B/DX 227B). Adelphia increased its equity and recorded a receivable, not cash, from Highland Holdings in exchange for the stock

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[38] Adelphia eventually used the $368 million cash proceeds for its own purposes. It paid down preexisting debt of two subsidiaries, UCA ($232 million) and Chelsea Communications ($136 million) (Tr. 368; DX 163 at 29716-19, DX 221B/DX 227B).

(Tr. 250-51; DX 103, DX 104, DX 221B/DX 227B). Highland Holdings then assigned the Class B shares to Highland 2000, another Rigas Entity that was not a co-borrower (Tr. 250-51; DX 105-DX 109; DX 163 at 29749, DX 221B/DX 227B).

Instead of accepting the $368 million in loan proceeds as cash, Adelphia issued new equity to a Rigas Entity. The receivable on Adelphia's books owing from Highland Holdings as consideration for Adelphia's equity and the payable on Adelphia's books owing to Hilton Head Communications from the loan proceeds netted to zero (Tr. 1960-61; DX 221B/DX 227B).

Dearlove urges me to infer that the co-borrowers intended Hilton Head Communications to draw on the 1999 credit agreement, and that the initial draw and cash receipt was recorded to UCA in error. Adelphia's accounting personnel did not correct the error by having UCA return the cash to the lender so that the lender could rewire the cash to the proper entity. This would have allowed Hilton Head Communications to send the cash to Highland Holdings, so that Highland Holdings could send the cash back to Adelphia. Instead, Adelphia's accounting personnel corrected the misposting through journal entries. Adelphia kept the cash, which was consideration for the issuance of stock. Dearlove contends that, in substance, no receivable was created for the $368 million stock purchase, because an affiliated receivable was offset by an affiliated payable (Tr. 1961). In essence, the accounting entries attempted to recast the transaction as showing the Rigas Entities paying cash for their newly issued Adelphia Class B common stock.

Dearlove's argument is unpersuasive. First, it demonstrates that Adelphia, Deloitte, and Dearlove had a very expansive understanding of "cash." They assumed that booking an affiliate receivable or an affiliate payable was the same as receiving cash, because all participants in Adelphia's centralized treasury system had a call on cash (Tr. 177-79, 739-40). At a bare minimum, this assumption conflicts with Dearlove's claim that there was no commingling of funds and demonstrates the need for Adelphia to disclose the workings of its centralized treasury system. See infra pp. 47-49. Second, Adelphia's claim of a misposting is dubious. The co-borrowers clearly instructed the lenders to wire funds to an account belonging exclusively to UCA (DX 35). There is no evidence that Deloitte ever tested management's representation that the lender made a clerical error, or that Adelphia's accounting department quickly corrected the error. In fact, Dearlove swallowed whole management's self-serving representation. He continued to parrot it at the hearing as if the clerical error was undisputed (Tr. 1959).

I find as a fact that the $368 million loan was originally intended for UCA. Thus, ownership of the loan proceeds rested with Adelphia. When Adelphia recorded a receivable for the issuance of its equity from Highland Holdings, it became subject to the provisions of EITF 85-1. Because the only consideration given in exchange for the $368 million in equity was a receivable from Highland Holdings, all the new equity should have been offset by the receivable within the equity section of Adelphia's consolidated balance sheet. It does not matter that all the journal entries were completed before issuance of the 2000 Financial Statements. Netting the receivable and the payable created no cash for Adelphia.

Adelphia's balance sheet treatment of the January 2000 direct placement violated GAAP in two ways. First, because UCA, an Adelphia subsidiary, initially drew down $368 million,

Adelphia was the primary obligor for that amount. Adelphia could not remove that amount from its balance sheet because it did not pay the debt and the lender did not release it from its obligation to pay. See FAS 125 ¶ 16. Second, Adelphia failed to record the transaction as a stock subscription, as required by EITF 85-1 and Rule 5-02.30 of Regulation S-X.[39] As a result, the financial statements were materially misleading.

July 2000 Direct Placement

In July 2000, Highland Prestige Georgia, a Rigas Entity co-borrower, drew down $145 million under the 2000 credit agreement (Tr. 265, 371, 403, 1960; DX 163 at 29538, DX 221C). Highland Prestige Georgia transferred the money to Highland Holdings, a Rigas Entity that was not a co-borrower (Tr. 374, 403; DX 221C). Highland Holdings then transferred $144,537,533 to Adelphia in exchange for shares of Adelphia stock (Tr. 265, 374; DX 163 at 29538-39, DX 221C). Adelphia recorded an increase in equity (Tr. 265-66; DX 163 at 29538, 29545, 29591, DX 221C). Highland Holdings assigned the Adelphia shares to its subsidiary, Highland 2000 (Tr. 266; DX 106-DX 109, DX 163 at 29538, DX 221C).

At the end of the transaction, Adelphia reported an increase in cash and an increase in equity (Tr. 266, 1961; DX 221C). Adelphia did not report an increase in debt. The Rigases ended up with debt and stock ownership (Tr. 374, 1961). Adelphia did not create a receivable for the $144,537,533 stock purchase (Tr. 1961). The Division maintains that it should have done so, and that the failure to do so violated EITF 85-1 and Rule 5-02.30 of Regulation S-X.

The Division concedes that Adelphia received cash for the July 2000 direct placement, but it objects to the fact that the Rigas family used co-borrowed funds to finance the purchase (Div. Br. at 34). The Division argues that the transaction was a stock subscription, and violated EITF 85-1 because the consideration given to Adelphia was really a receivable that should have been netted against any increase in equity. According to the Division, the receivable was required because: (1) the cash came from the proceeds of a co-borrowed loan for which Adelphia was jointly and severally liable; (2) Highland Prestige Georgia lacked the wherewithal to repay its own co-borrowings; and (3) thus, Adelphia assumed debt for the stock it issued to the Rigas family. The Division has not sustained its burden of proving that Highland Prestige Georgia lacked the wherewithal to repay its own co-borrowings. Because the Division has not shown that Adelphia's contingent liability for the $145 million draw was "probable" or even "reasonably possible," the evidence does not support this claimed GAAP violation.

Deloitte's Interim Review and<br>Audit of the Direct Placements

Adelphia reported the January 2000 direct placement as a subsequent event in its 1999 Financial Statements (RX 6 at 88). Adelphia reported the January 2000 direct placement again

[39] OIP ¶ II.C.32 & n.3 allege that Adelphia should also have posted an additional $7 million as contra-equity during January 2000 (for a total of $375 million). The Division did not address the $7 million transaction in its pleadings, and I consider the issue to be abandoned.

in its 2000 Financial Statements (DX 31 at 82). The auditors considered the transaction on both occasions (Tr. 1962-63).

Hofmann reviewed a work paper reflecting that Highland Holdings had exchanged a receivable for the shares of stock in the January direct placement (Tr. 827-29; DX 75). Brown described a conversation with Caswell in March 2001 (Tr. 64-66). According to Brown, Caswell "possibly" thought that the January direct placement should be recorded as a stock subscription (Tr. 65). Brown strongly disagreed with Caswell and dismissed the idea summarily (Tr. 64-65). Caswell could not recall such a conversation (Tr. 472-73). I credit Brown's testimony.

In April 2000, Hofmann requested documents from Adelphia relating to the closing of the January direct placement (Tr. 740-41; DX 71). If Deloitte received any such documents, they are not a part of the record. At some point, Hofmann gave Werth accounting literature about how to record stock subscriptions (Tr. 228-30). According to Werth, he and Hofmann then had a "dialogue" about whether the two transactions were equity offerings or only stock subscriptions (Tr. 229). Hofmann could not recall such a discussion (Tr. 740). I credit Werth's testimony.

Based on a review of the quarterly work papers, the auditors concluded that the amounts recorded by Adelphia for the direct placements appeared reasonable (Tr. 747-48; DX 72, tick mark (g)). There is no evidence as to whether Deloitte looked beyond the amounts to the substance of the transactions. There is no explanation as to how the auditors were able to find comfort with Adelphia's accounting treatments.

Dearlove Violated GAAS

Dearlove knew that both direct placements had occurred. He also knew that the dates and amounts of both transactions had been disclosed in Adelphia's quarterly and annual reports (Tr. 471, 1958, 2244-46). Dearlove testified that the engagement team did not bring to his attention the mechanics of the two direct placements (Tr. 1962-63, 2245-47). Neither Caswell nor Hofmann could recall discussing the subject with Dearlove during the audit (Tr. 473, 749).

Dearlove cannot satisfy his GAAS obligation to supervise by showing that his subordinates did not bring matters to his attention. AU §§ 230.06, 311.11, 311.13 envision active supervision, and Dearlove failed to provide it on the audit of the direct placements. Dearlove knew these transactions were large and, as to the source of the funds, untested. He had a duty to inquire about them, or direct his staff to do so, rather than relying on his assistants to make the sole judgment on their own. Deloitte's audit plan and AU § 334 required the engagement team to understand the impact of the material related-party transactions on Adelphia's financial statements (DX 81). The audit plan and AU § 312 required the engagement team to investigate the sources of financial resources supporting significant or unusual transactions (DX 81). There is little doubt that the direct placements were significant and unusual transactions: the co-borrowers that drew down the funds were not the entities that "bought" Adelphia securities. Yet the auditors exhibited no curiosity as to why the transactions had been structured the way they were. In each of these areas, I conclude that Dearlove violated GAAS.

There is no evidence that the engagement team tested Adelphia's decision to record the two transactions as stock purchases, rather than stock subscriptions. There is no evidence that the engagement team took steps to ascertain the source of the funds used for the stock purchases (Tr. 748-49; DX 72). After Brown rejected Caswell's suggestion that the January direct placement might be a stock subscription, the engagement team backed off. The auditors' failure to conduct further testing of this $368 million transaction violated AU §§ 230.07-.08. I conclude that Dearlove violated his GAAS obligations to supervise the audit team and to employ the increased professional skepticism that the known risks of the audit required.

**E. Disclosure of Related-Party Transactions**

The OIP contends that Adelphia's 2000 Financial Statements failed to disclose certain material related-party transactions, as required by GAAP. It also asserts that Dearlove violated GAAS by failing to ensure that Adelphia disclosed the specifics of such transactions.

What GAAP and GAAS Require

Statement of Financial Accounting Standards No. 57, Related Party Disclosures (March 1982) (FAS 57), requires financial statements to include disclosures of material related-party transactions. FAS 57 ¶ 2. The disclosure must include the nature of the relationship(s) involved; a description of the transactions; the dollar amounts of transactions; and amounts due from or to related parties as of the date of each balance sheet presented. Id. Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis. FAS 57 ¶ 3. FAS 57 is the only standard at issue in this part of the proceeding.[40]

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[40] Twelve days before the hearing commenced, the Division alleged for the first time that Adelphia's 2000 annual report also contravened Item 404(a) of Regulation S-K, Certain Relationships and Related Transactions, 17 C.F.R. § 229.404(a) (Div. Prehearing Br. at 19-20). Item 404(a) of Regulation S-K requires registrants to describe any transactions or series of similar transactions to which the registrant or any of its subsidiaries was a party and in which its directors, officers, and their family members have a direct or indirect material interest. See Felicia H. Kung, "The Regulation of Corporate Bond Offerings: A Comparative Analysis," 26 U. Pa. J. Int'l Econ. L. 409, 450 (Fall 2005) (noting that the disclosure requirements for related-party transactions in FAS 57 are "relatively general," while the disclosure requirements for related parties in Item 404(a) are "significantly more detailed"). The Division continued to press its Regulation S-K claim after the hearing (Div. Br. at 37-38).

Regulation S-K applies to the portions of a registrant's annual report that are not financial statements. See 17 C.F.R. §§ 229.10(a)(2), .10(d); see also In re Enron Corp. Sec., 235 F. Supp. 2d 549, 619-20 (S.D. Tex. 2002) ("Item 404 of Regulation S-K imposes requirements for disclosure of transactions in non-financial statement portions of SEC filings. . ."). The Division has not even attempted to harmonize its Regulation S-K theory with AU § 550.04, which only requires auditors to review Regulation S-K disclosures to determine their effect on the financial statements.

For each material related-party transaction for which FAS 57 requires disclosure, the auditor should consider whether he has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related-party transactions, the effects of the transactions on the financial statements. AU § 334.11. He should then evaluate all the information available to him concerning the related-party transaction and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements. Id.

The presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters. AU § 431.02. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including the terminology used and the amount of detail given. Id. An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time. Id. If management omits from the financial statements, including the accompanying notes, information that is required by GAAP, the auditor should express a qualified or an adverse opinion and should provide the information in his report, if practicable. AU § 431.03.

**(1) Related-Party Transactions Alleged in the OIP to be Insufficiently Disclosed**

Adelphia and the Rigas family engaged in thousands of related-party transactions. While the OIP is hardly a model of clarity, I find that it gave Dearlove sufficient notice that five types of related-party transactions were alleged to have been insufficiently disclosed in the Notes to Adelphia's 2000 Financial Statements: co-borrowed debt (OIP ¶¶ II.C.17, .20), netting and direct placements (OIP ¶¶ II.C.29, .32, .36), debt reclassifications (OIP ¶ II.C.32), and the centralized treasury system (the so-called cash management system) (OIP ¶ II.C.31). Dearlove is alleged to have violated GAAS because he did not insist on the Note disclosure required by FAS 57. With the exception of the cash management system, Dearlove does not dispute materiality.

Debt Reclassifications, Co-Borrowed
Debt, Direct Placements, and Netting

The Notes to Adelphia's 2000 Financial Statements did not disclose the debt reclassifications, in violation of FAS 57. Adelphia's Note disclosure of its guarantee for co-borrowed debt has been addressed previously. See supra pp. 31-33. The Notes disclosed

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The OIP focuses on alleged shortcomings in Adelphia's audited financial statements, not omissions from the text of Adelphia's annual report. The Commission did not allege a Regulation S-K violation in the OIP. The situation contrasts with the allegation that Adelphia's practice of netting violated not only GAAP, but also Commission Regulation S-X (OIP ¶¶ II.C.24-.25). Cf. In re Metricom Sec. Litig., 2004 U.S. Dist. LEXIS 7834, at *58 n.17 (N.D. Cal. May 4, 2004) (distinguishing an Item 404 claim, which had been pleaded, from a FAS 57 claim, which had not been pleaded, and refusing to consider the latter). Dearlove lacked fair notice of the Division's belated Regulation S-K charge. I decline to base any finding of improper professional conduct upon it.

Adelphia's direct placement of Class B shares, but they did not disclose that a stock subscription was involved. Nor did the Notes disclose that co-borrowed funds drawn by an Adelphia subsidiary had been used to fund the January 2000 direct placement. See supra pp. 40-43. The omission of these items left shareholders without knowledge that the consideration the Rigas family gave for their Class B shares was of questionable value. I conclude that this incomplete disclosure of the January 2000 direct placement also violated FAS 57. Dearlove failed to require Adelphia to include the appropriate disclosure in the notes to the financial statements. I further conclude that Dearlove violated his GAAS obligations to supervise, AU §§ 230.06, 311.11, 311.13, and to require appropriate disclosure, AU §§ 334.11, 431.01, and 431.03.

The Notes to Adelphia's 2000 Financial Statement disclosed that "[r]elated party receivables-net represent advances to managed entities . . . , John J. Rigas and certain members of his immediate family . . . , including entities they own or control . . ." (DX 31 at 73). The Division's expert minimized the value of this disclosure (Lesser Report at 51-54) ("virtually useless"). Lesser opined that Adelphia's disclosure was misleading because it mentioned only advances to other entities, but failed to mention that there were payables to these entities, as well. In Lesser's judgment, anyone reading the Note would assume that the $3 million in receivables on Adelphia's balance sheet represented only advances or that the payables against which the receivables were netted were insignificant. Thus, the netting disclosure omitted material information: the magnitude of the related-party transactions between Adelphia and the Rigas Entities. Dearlove did not challenge Lesser's opinion that the Note was misleading to the reasonable investor. I agree with the Division that the incomplete disclosure of netting violated FAS 57. By failing to require Adelphia to make the necessary disclosure, I further conclude that Dearlove violated his GAAS obligations under AU §§ 334.11, 431.01, and 431.03.

The So-Called Cash Management System

The OIP alleges that FAS 57 required the Notes to Adelphia's 2000 Financial Statements to disclose that: (1) Adelphia, its subsidiaries, Rigas Cable Entities, and Rigas non-Cable Entities participated in a cash management system; (2) Adelphia personnel maintained the financial records of these entities on a common general ledger; and (3) there was a continuous commingling of funds between and among the participants in the system (OIP ¶¶ II.B.9, II.C.30-.31).

The Division does not suggest that GAAP required the funds of Adelphia to be segregated from the funds of the Rigas Entities. Nor does it argue that the cash flows of the Rigas Entities somehow belonged to Adelphia. Thus, the issue presented for decision is not the propriety of commingling, but only the need to disclose the extent of the commingling in the notes to the financial statements pursuant to FAS 57.

The Deloitte engagement team, including Dearlove, knew that Adelphia managed a centralized treasury system for Adelphia, its subsidiaries, and the Rigas Entities, and recorded disbursements and receipts (Tr. 737-40, 909, 1951-53, 2249). Deloitte's Enterprise Risk Services group, which assisted in auditing clients' internal controls, tested Adelphia's general ledger system and determined that the receivables and payables were being accounted for accurately (Tr. 606-07, 1946; DX 10, DX 33, DX 34, DX 86.16).

Note 13 to Adelphia's 2000 Financial Statements (as amended) disclosed that Adelphia provided management and consulting services, including accounting services, to the Rigas Entities for a fee (DX 31 at 90, DX 156 at 12; RX 193 at 15). Dearlove contends that GAAP did not require any additional note disclosure (Tr. 1954-55).

Adelphia often paid expenses for Rigas Entity affiliates out of Adelphia's bank accounts, with balances settled at the end of each quarter (Tr. 59-60, 107). Dearlove emphasizes that Adelphia's general ledger system accurately accounted for the balances of each entity that participated in the centralized treasury system. As a result, he argues that there was no commingling and no need for public disclosure. Dearlove's position is difficult to reconcile with his assumption that booking an affiliate receivable or an affiliate payable was the same as receiving cash, because all participants in the centralized treasury system had a call on cash. See supra p. 42.

Although no witness described the operation of the cash management system, I agree with the Division that the commingling of funds through the centralized treasury system constituted a related-party transaction that should have been disclosed to the public and that Adelphia's failure to do so violated FAS 57. Adelphia's disclosure in Note 13 inadequately explained the nature of the financial services Adelphia provided to the Rigas Entities through the centralized treasury system, the dollar amounts involved, and the amounts due from or to the Rigas Entities as of the date of the financial statements. Investors were not aware that the commingling contributed to thousands of other related-party transactions. Nor were investors able to determine whether the transactions were fair to Adelphia. By failing to insist on note disclosure regarding the commingling of funds of related parties through the centralized treasury system, Dearlove violated AU §§ 334.11, 431.01, 431.03.[41]

I give little evidentiary weight to the Division's claim that Adelphia's new management "felt it necessary to disclose the facts" about the cash management system in a Form 10-K it filed in December 2004 (Div. Prehearing Br. at 20; Div. Prop. Find. # 254; Div. Br. at 38). The fact that Adelphia's new management reached a different conclusion about disclosure from Adelphia's old management does not establish FAS 57 or GAAS violations in connection with Adelphia's 2000 Financial Statements. Cf. Malone v. Microdyne Corp., 26 F.3d 471, 478-80 (4th Cir. 1994) (holding that a revised Form 10-K is a subsequent remedial measure that cannot be used to prove negligence or culpable conduct in connection with the original Form 10-K); Krouner v. Amer. Heritage Fund, Inc., 899 F. Supp. 142, 147 (S.D.N.Y. 1995) (same, as to a

[41] My conclusion is based on the way the OIP framed the issue as a FAS 57 violation. It may well be that detailed disclosure of the mechanics of the centralized treasury system was not required by FAS 57, although it was a required disclosure item under Item 404(a) of Regulation S-K. See infra n.43 & accompanying text. As the issue has been presented, I conclude that some disclosure of the commingling of funds was required in the notes to the financial statements so that investors could understand the effect of the commingling on the other related-party transactions. FAS 57 ¶ 2(b).

subsequent prospectus).[42] Moreover, many of the facts known to Adelphia's new management in December 2004 were unknown to Deloitte when it audited the 2000 Financial Statements.

Nonetheless, the conduct of Adelphia's new management is relevant in some ways. Adelphia's new management has continued to use the centralized treasury system until the present, with the knowledge of the Commission's staff (Tr. 386, 1222, 1347-48). When Adelphia's new management filed its annual reports for 2001, 2002, and 2003, it discussed the mechanics of the centralized treasury system principally in the text of its annual report (DX 150 at 31-32) (subject to Item 404(a) of Regulation S-K), rather than in Note 13 of its audited financial statements (DX 150 at 237-40) (subject to FAS 57).[43]

**(2) Related-Party Transactions Not Identified in the OIP as Insufficiently Disclosed**

Shortly before the hearing, the Division informed Dearlove that it would challenge Adelphia's disclosure (and Deloitte's audit) of two additional related-party transactions (Lesser Report at 63-64, 66-67; Div. Prehearing Br. at 18-20). These transactions involved Adelphia's acquisition of land and timber rights for approximately $26.5 million and Adelphia's purchase of approximately $15 million in furniture from Eleni Interiors, Inc. (Eleni Interiors). Neither transaction had been identified in the OIP.

Dearlove complains, with considerable justification, that he lacked sufficient time to prepare a full defense for these accusations. The first notice to Dearlove of these specific charges came well after his attorneys had conducted a substantial portion of the document review in the case. As soon as the Division raised these new issues, Dearlove objected (Prehearing Conference of Dec. 21, 2005, at 11-13; Prehearing Conference of Jan. 20, 2006, at 31-37). He preserved his objection at the hearing (Tr. 288-94), and now renews it in his brief (Dearlove Br. at 14, 149-51).

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[42] Both Malone and Krouner involved the application of Rule 407 of the Federal Rules of Evidence (subsequent remedial measures are inadmissible to prove negligence or culpable conduct in connection with the event that prompted the measures). The Commission has invoked Federal Rule of Evidence 407 in a disciplinary proceeding brought under former Rule 2(e). See Peat, Marwick, Mitchell & Co., 45 S.E.C. 789, 871 n.95 (1975) (settled case). Other agencies also apply Federal Rule of Evidence 407 in their administrative proceedings. See, e.g., 29 C.F.R. § 18.407 (U.S. Dept. of Labor).

[43] In Note 13 to the audited financial statements for 2001, 2002, and 2003, Adelphia's new management disclosed that the company provided management and administrative services, including cash management services, to the Rigas Cable Entities for a fee (DX 150 at 238). This was quite similar to the disclosure provided in Note 13 to Adelphia's amended 2000 Financial Statements. The only additional disclosure language in Adelphia's 2001-2003 Financial Statements was a brief acknowledgement that any cash flows of the Rigas Cable Entities are deposited into or deducted from Adelphia's cash accounts (DX 150 at 238).

While the complaint in an administrative proceeding is not judged by the standards applied to a criminal indictment, a respondent in an administrative proceeding must still be able to understand the issues and have a full opportunity to justify his conduct at the hearing. Aloha Airlines, Inc. v. CAB, 598 F.2d 250, 262 (D.C. Cir. 1979) (collecting cases). The question on review is the fairness of the whole procedure. Id. The Commission has repeatedly emphasized an obligation to ensure that its administrative proceedings are conducted fairly in furtherance of the search for the truth and a just determination of the outcome. Clarke T. Blizzard, 55 S.E.C. 650, 653 (2002) (collecting cases).

If the timber rights and Eleni Interiors transactions were so important to the Division's case against Dearlove, there is no legitimate reason why they were not specifically identified in the OIP. Paragraphs 114 and 116 of the Commission's civil injunctive complaint in SEC v. Adelphia, No. 02-Civ.-5776 (KW) (S.D.N.Y.), raised the timber rights transaction with particularity (official notice). The Commission's Settlement Order in Deloitte discussed "furniture retailing" and "Doris Rigas's design company" with particularity. See Deloitte, 85 SEC Docket at 1113, 1118. It is plain that the Commission can provide the appropriate notice when it chooses to do so. See supra p. 46.

The Division acknowledges that Adelphia engaged in thousands of related-party transactions, but it simply assumes that Dearlove should have been prepared to defend Adelphia's disclosure (and Deloitte's audit) of every one of them (Div. Reply Br. at 24-26). I disagree because ambiguity of this sort denied Dearlove a fair opportunity to defend his conduct. Cf. Rita J. McConville, 85 SEC Docket 3127, 3138-39 n.27 (June 30, 2005) ("We do not base our findings as to McConville's liability on the . . . press release. . . . The OIP did not charge misstatements in the press release."); Ponce, 54 S.E.C. at 822 n.49 ("The Division contends that Ponce . . . was auditing some of his own work. . . . This conduct was not charged in the [OIP], however, and we do not consider it in assessing Ponce's conduct or the appropriate sanctions.").

The Division brushes off Dearlove's claim of unfair prejudice by observing that Dearlove's proposed exhibit list contained eight documents relating to the timber rights transaction (Prehearing Conference of Jan. 20, 2006, at 32; Div. Reply Br. at 26). This only shows that Dearlove's attorneys proved resourceful when forced to scramble at the last minute. It does not mean that it was fundamentally fair to require them to scramble. The Division's argument also ignores the disclaimer in Dearlove's exhibit list. Dearlove objected to the introduction of any evidence relating to the timber rights transaction, and stated that he planned to use the documents in rebuttal if the Division was permitted to introduce evidence relating to the timber rights transaction during its case-in-chief.

The Division further argues that Dearlove "opened the door" to full consideration of the timber rights transaction when his attorney asked Brown three questions about timber rights (Tr. 169, 292). These preliminary questions (and Brown's innocuous answers) did not expose Dearlove to potential liability for an entirely new charge, as the Division appears to believe. See United States v. Bursey, 85 F.3d 293, 296 (7th Cir. 1996) ("[T]he Rules of Evidence do not simply evaporate when one party opens the door on an issue."). "Even after the door has been opened, the district court is required to weigh the need for and value of curative admissibility of previously inadmissible evidence . . . against the potential for undue delay, confusion, and

prejudice." Manuel v. City of Chicago, 335 F.3d 592, 597 (7th Cir. 2003). I have conducted the appropriate balancing test, and I conclude that the need for and value of curative admissibility was slight and the potential for prejudice to Dearlove was great.

In the context of the entire proceeding, the Division's effort to press forward on the timber rights and Eleni Interiors issues is overkill. As a matter of fairness to Dearlove, I decline to consider these untimely allegations.

## CONCLUSIONS OF LAW

### A. Improper Professional Conduct

Rule 102(e)

Rule 102(e)(1) of the Commission's Rules of Practice provides that the Commission may censure a person or deny a person the privilege of appearing or practicing before it after finding that the person has engaged in improper professional conduct. With respect to persons licensed to practice as accountants, "improper professional conduct" is defined in Rule 102(e)(1)(iv) as meaning:

> (A) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
> (B) either of the following two types of negligent conduct:
> > (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted;
> > (2) 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.

Recklessness can be established by showing an extreme departure from the standard of ordinary care for auditors. James Thomas McCurdy, CPA, 82 SEC Docket 271, 285 & n.21 (Feb. 4, 2004) (collecting cases), aff'd, 396 F.2d 1258 (D.C. Cir. 2005). In adopting the "highly unreasonable" standard, the Commission explained that it is "an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness" used in cases brought under the antifraud provisions of the Exchange Act. Amendment to Rule 102(e), 68 SEC Docket at 710 & n.42. The "highly unreasonable" standard is an objective standard. The conduct at issue is measured by the degree of the departure from professional standards and not the intent of the accountant. Id. at 710. The Commission further explained that "heightened scrutiny" is warranted "when matters are important or material, or when warning signals or other factors should alert an accountant" to a heightened risk. Id. at 711.

The Commission defined the term "unreasonable" under Rule 102(e)(1)(iv)(B)(2) as "an ordinary or simple negligence standard." Id. at 712. It defined the term "repeated instances" as meaning "more than once." Id. The Commission explained that the standard can be satisfied by

"as few as two separate instances of unreasonable conduct occurring within one audit." Id. Unlike the "recklessness" and "highly unreasonable" standards, the Commission must make a specific finding that each instance of unreasonable conduct indicates a lack of competence. Id.

The OIP alleges that Dearlove engaged in improper professional conduct under each of these definitions (OIP ¶¶ II.C.45-.46).

## Applicable Professional Standards

The applicable professional standards for judging Dearlove's conduct are GAAP, GAAS, and the Commission Regulations identified in the OIP. Id. Deloitte's Accounting and Audit Procedures Manual, prominently cited in OIP ¶¶ II.C.10-.11, .13, is not part of the applicable professional standards.[44] The Commission has already found that Deloitte's risk management program for clients deemed to have "much greater than normal" audit risk was not required by GAAS. Deloitte, 85 SEC Docket at 1114. The Division has acknowledged that Deloitte's internal standards for its audits exceed the requirements of GAAS (Prehearing Conference of Oct. 28, 2005, at 30-32; Tr. 864-65, 867-68, 871). Accordingly, Deloitte's internal standards are not part of the applicable professional standards, either.

## Dearlove Engaged in Repeated Instances of Unreasonable Conduct and One Instance of Highly Unreasonable Conduct

Dearlove failed to comply with GAAS because (1) he signed an unqualified audit opinion despite the financial statements' numerous GAAP violations (AU § 431.03); (2) he failed to supervise the engagement team to ensure that they brought matters to his attention, such as the debt reclassifications and the funding for the direct placements (AU §§ 230.06, 311.11, 311.13); (3) he failed to apply professional skepticism with respect to explanations and representations of management or the audit evidence he was provided to support conclusions about the proper recordation and disclosure of co-borrowed debt and the direct placements (AU §§ 230.07-.08, 333.02); and (4) he obtained insufficient competent evidential matter to support his conclusions about the proper recordation of co-borrowed debt, the propriety of netting related-party

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[44] Courts recognize that it would not be fair to sanction a firm's auditors if the firm imposes standards upon itself that may be stricter than the industry-wide standards. See In re Mid American Waste Sys., Inc., Sec. Litig., 1997 U.S. Dist. LEXIS 22752, *4-10 (D.N.J. Dec. 9, 1997); Gohler v. Wood, 162 F.R.D. 691, 694-96 (D. Utah 1995); Tonnemacher v. Sasak, 155 F.R.D. 193, 195 (D. Ariz. 1994); In re Worlds of Wonder Sec. Litig., 147 F.R.D. 214, 215-17 (N.D. Cal. 1992); In re ContiCommodity Serv., Inc., Sec. Litig., 1988 U.S. Dist. LEXIS 4812, *2-5 (N.D. Ill. May 23, 1988). These cases recognize that an accounting firm's internal manuals are not publicly available. They hold that such manuals do not and cannot create industry-wide norms, or alter a firm's obligations to follow GAAP or GAAS. Cf. In re Ikon Office Solutions, Inc., Sec. Litig., 131 F. Supp. 2d 680, 699-702 (E.D. Pa. 2001) (rejecting plaintiff's claim that Ikon's internal accounting practices were substantially equivalent to GAAP and that, therefore, deviations from Ikon's internal accounting practices were also deviations from GAAP).

transactions, and the appropriate accounting for the debt reclassifications and direct placements (AU §§ 326.01, 334.09, 339.01-.02, 339.05, 508.22).

Based on the discussion of accounting and auditing issues above, I conclude that Dearlove engaged in repeated instances of unreasonable conduct, each of which resulted in a violation of applicable professional standards, and each of which indicates a lack of competence to practice before the Commission. With respect to the known risk of fraud, misstatement, or error arising from Adelphia's numerous related-party transactions, I also conclude that Dearlove engaged in a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which he knew that heightened scrutiny was warranted. As a result, Dearlove is subject to discipline under Rule 102(e)(1)(ii).[45]

In reaching these conclusions, I have considered four matters that Dearlove offered in mitigation. First, I have not given much weight to Dearlove's reliance on a comment letter that Adelphia received from the Assistant Director of the Commission's Division of Corporation Finance in September 2000 (RX 97) (comment letter). The comment letter analyzed the Forms 10-K and 10-Q that Adelphia and its subsidiaries had filed for the year ended December 31, 1999, and the quarter ended June 30, 2000. The comment letter raised questions and challenged Adelphia's financial presentation about a variety of accounting issues. However, it did not question or criticize Adelphia's accounting for co-borrowing, its netting of related-party transactions, or any other matter within the scope of the OIP (Tr. 1918-19; RX 97).

Dearlove reviewed the comment letter and assisted Adelphia in formulating its response (Tr. 1920). Although Dearlove did not equate the silence of the Commission's staff on certain issues with approval, he took some comfort about issues that the Division of Corporation Finance did not raise in the comment letter (Tr. 1922-23). The comment letter reinforced Dearlove's view that the accounting as presented was appropriate because it indicated to him that a regulatory reviewer had not raised concerns (Tr. 1922-23). While this may have been a rational inference for Dearlove to draw,[46] I am precluded from giving much weight to Dearlove's reliance on the comment letter. See Section 26 of the Exchange Act; see also Capital

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[45] The weight of the evidence does not establish that Dearlove also engaged in intentional, knowing, or reckless conduct that resulted in a violation of applicable professional standards. Rather, based on the findings and conclusions herein, Dearlove's improper professional conduct falls most squarely within Rules 102(e)(1)(iv)(B)(1)-(2).

[46] Dearlove's reaction to the staff's silence was identical to Macdonald's reaction to the staff's silence four years later under similar circumstances. Shortly before Adelphia filed its overdue Form 10-K for 2001, 2002, and 2003, Macdonald identified several accounting issues that he believed merited discussion with the Commission's staff (RX 313). Macdonald and other Adelphia representatives made a presentation to the Divisions of Enforcement and Corporation Finance in November 2004 (Tr. 1221-23). The absence of objections by the Commission's staff gave Macdonald comfort that he was proceeding correctly (Tr. 1223). Once Adelphia filed its overdue annual reports, the November 2004 meeting did not prevent the Commission's staff from sending Macdonald a comment letter, questioning Adelphia's treatment of fifteen issues (Tr. 1226).

Funds, Inc. v. SEC, 348 F.2d 582, 588 (8th Cir. 1965); SEC v. Culpepper, 270 F.2d 241, 248 (2d Cir. 1959). The Division of Corporation Finance, unlike Deloitte, did not audit Adelphia. The Commission staff's lack of comment on any particular accounting issue does not resolve the issue of whether Adelphia's accounting for that issue complied with GAAP or whether Dearlove complied with GAAS.

Second, I have given only limited weight to Dearlove's claim that he is entitled to credit for improving the note disclosure of co-borrowed debt in Adelphia's 2000 Financial Statements, as compared to what had been disclosed in Adelphia's 1999 Financial Statements. Lesser opined that the disclosure was better in 2000, but he still considered it to be misleading (Tr. 1498, 1502) ("There was an improvement, but not a significant improvement."). Lesser's testimony tends only to negate the Division's claim that Dearlove behaved recklessly.

Third, I have given only limited weight to Dearlove's claim that nobody on the engagement team brought the debt reclassifications and the mechanics of the direct placements to his attention. This testimony tends only to negate the Division's claim that Dearlove behaved recklessly. Cf. KPMG Peat Marwick LLP, 54 S.E.C. 1135, 1176 (2001) ("Ordinarily, the phrase 'should have known' is classic negligence language."), recon. denied, 55 S.E.C. 1 (2001), pet. denied, 289 F.3d 109 (D.C. Cir. 2002).

Fourth, I have given due regard to the fact that Dearlove stood up to Adelphia management during the third quarter review for 2000. As part of that interim review, Deloitte learned that Adelphia planned to recognize revenue for warrants connected to a transaction with Wink Communications, Inc. (Wink) (Tr. 67-68, 296, 1843-51). Deloitte concluded that there was not enough evidence to support the existence of the underlying transaction, which Timothy Rigas had negotiated at the end of the quarter (Tr. 1841). Dearlove told Adelphia management that it needed to reverse the revenue it intended to recognize in connection with the Wink transaction (Tr. 68, 296, 1843-51).

Despite receiving verbal assurances that Adelphia would reverse the revenue, Adelphia continued to claim the revenue in its draft quarterly report. As a result, Dearlove went directly to Timothy Rigas and threatened that Deloitte would resign the engagement if Adelphia did not reverse the revenue (Tr. 478, 756, 1843-52). Adelphia ultimately relented, and did not record the revenue (Tr. 68-69, 478).

Brown and Werth minimized the dollar amount of the Wink transaction, while Caswell and Dearlove insisted that it was larger (Tr. 67-68, 296, 477-78, 1842). Dearlove also testified that he considered the quantitative materiality of the transaction to be irrelevant, because it involved a known error (Tr. 1849-51). Cf. Staff Accounting Bulletin No. 99, Materiality (Aug. 12, 1999) (SAB 99) (expressing the Commission staff's view that misstatements in an annual report are not immaterial simply because they fall beneath a numerical threshold). Although SAB 99 does not directly apply to quarterly reporting periods, it was surprising that the Division appeared to dismiss the Wink transaction as quantitatively immaterial (Div. Prop. Find. ## 276-77). It does not matter that Brown and Werth could not recall Dearlove's threat to resign, because Dearlove delivered his ultimatum to Timothy Rigas, not Brown or Werth (Tr. 69, 167, 297, 398, 1846). I credit Dearlove's testimony about the contentious nature of the Wink

transaction, and I treat it as a mildly mitigating factor. However, the Wink transaction does not "balance the scales" when compared with the other violations of GAAP and GAAS proven here.

**B. Causing Violations of the Reporting, Record Keeping, and Internal Accounting Control Provisions of the Exchange Act**

The OIP alleges that Adelphia violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 13a-1 and 12b-20 (OIP ¶ II.C.41.-.42).[47] It also alleges that Dearlove was a cause of Adelphia's violations (OIP ¶¶ II.C.43).[48]

Primary Liability

Section 13(a) of the Exchange Act and Exchange Act Rule 13a-1 require issuers of securities to file annual reports with the Commission and to keep the information current. The obligation to file these reports includes an obligation that the filings be accurate. Robert W. Armstrong, III, 85 SEC Docket 3011, 3029 & n.56 (June 24, 2005) (citing United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991)). Under Exchange Act Rule 12b-20, an issuer has a duty to provide any additional material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. Id. at 3029 & n.58; Ponce v. SEC, 345 F.3d 722, 735 (9th Cir. 2003).

Adelphia violated Section 13(a) of the Exchange Act and Rules 13a-1 and 12b-20 because its 2000 Form 10-K included financial statements that did not, as represented, accord with GAAP. Cf. Armstrong, 85 SEC Docket at 3029; KPMG, 54 S.E.C. at 1173-74.

Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect their transactions and dispositions of assets.

Adelphia violated Section 13(b)(2)(A) of the Exchange Act by making and keeping false and misleading entries on its books and records concerning a debt reclassification and a direct placement of Class B common stock. It therefore made and kept books and records that did not accurately and fairly reflect its transactions and dispositions of assets. Cf. Armstrong, 85 SEC Docket at 3030.

In relevant part, Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that

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[47] Proof of scienter is not necessary to establish violations of these provisions. SEC v. McNulty, 137 F.2d 732, 740-41 (2d Cir. 1998); SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 751 (N.D. Ga. 1983); SEC v. Wills, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

[48] Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. Howard v. SEC, 376 F.3d 1136, 1141 (D.C. Cir. 2004); KPMG, 54 S.E.C. at 1175. Negligence is the failure to exercise reasonable care or competence. Byron G. Borgardt, 80 SEC Docket 3559, 3577 & n.35 (Aug. 25, 2003).

transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP and to maintain accountability for assets.[49]

Internal controls are the policies and procedures adopted within an organization that operate as a means of promoting operational efficiency, reliability in financial reporting, and encouraging adherence to managerial policies, applicable laws, and regulations. World-Wide Coin, 567 F. Supp. at 750. Internal controls are not required to be foolproof. They could be implemented improperly due to carelessness, misunderstanding, or misjudgment, as well as circumvented by collusion or overridden at the direction of management. AU § 319.16. The cost of an entity's internal control should not exceed the benefits that are expected to be derived. AU § 319.17. "There are no specific standards by which to evaluate the sufficiency of controls; any evaluation is inevitably a highly subjective process in which knowledgeable individuals can arrive at totally different conclusions." World-Wide Coin, 567 F. Supp. at 751.

The Division presented limited evidence about Adelphia's system of internal accounting controls (DX 10 at DT 90571-72, DX 86.1, DX 86.16).[50] The Division's expert did not opine on whether Adelphia's system failed to provide the reasonable assurances the statute requires. In short, the Division failed to show what the controls were and why they were deficient. Lesser briefly addressed Deloitte's audit of internal controls, but he did not discuss AU § 319 (Lesser Report at 43; Love Report at 38, 50).[51] The Division's post-hearing pleadings make only cursory references to Section 13(b)(2)(B) of the Exchange Act (Div. Prop. Find. # 319, Div. Br. at 42 n.218, 60; Dearlove Br. at 158-60).

Instead, the Division worked backwards. It began with the fact that there were three debt reclassifications during 2000, and the assumption that there were numerous false journal entries. It then urged me to infer that, therefore, Adelphia's internal accounting controls must have failed to provide the "reasonable assurances" required by Section 13(b)(2)(B) of the Exchange Act. Finally, it asked me to conclude that, because Adelphia's internal accounting controls were lacking, therefore, Deloitte's audit of internal accounting controls must have been a cause of the inadequacy. This line of reasoning fails because it attempts to read the "reasonable assurances" language out of the statute. The Division wrongly assumes that, any time there are proven violations of Section 13(b)(2)(A) of the Exchange Act, there must automatically be a violation of Section 13(b)(2)(B), as well. One court has recently rejected this type of hindsight analysis. Cf. Marsden v. Select Medical Corp., 2006 U.S. Dist. LEXIS 16795, at *46-50 (E.D. Pa. Apr. 6,

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[49] Section 13(b)(7) of the Exchange Act defines the term "reasonable assurances" as meaning "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

[50] The discussion in DX 150 at 213-15 is pure hindsight, and adds nothing that is relevant.

[51] Although an auditor's failure to evaluate a client's internal accounting control system may violate GAAS for purposes of Rule 102(e), it does not prove a primary violation of Section 13(b)(2)(B) of the Exchange Act.

2006). The Commission's analysis of Sections 13(b)(2)(A)-(B) in McConville, 85 SEC Docket at 3145-47 & n.47, cannot be stretched to support the Division's approach, either.

The debt reclassifications do not necessarily establish that Adelphia's system of internal accounting controls was inadequate.[52] Notwithstanding the existing controls, Adelphia's senior management was able to circumvent them. The involvement of senior management in wrongdoing makes it unlikely that any system of internal accounting controls would have prevented the debt reclassifications and the improper journal entries. Cf. Albert Glenn Yesner, CPA, 75 SEC Docket 220, 258-61 (May 22, 2001), final, 75 SEC Docket 648 (June 19, 2001). If the Division wanted to demonstrate that management overrides are themselves evidence of inadequate internal accounting controls, it should have provided testimony to support that position. The weight of the evidence fails to show that Adelphia violated Section 13(b)(2)(B) of the Exchange Act.

Causing Liability

Section 21C(a) of the Exchange Act specifies that a person is a cause of another's violation if the person knew or should have known that his or her act or omission would contribute to the violation.

The Commission has determined that causing liability under Section 21C(a) requires findings that: (1) a primary violation occurred; (2) an act or omission by the respondent caused the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. See Robert M. Fuller, 80 SEC Docket 3539, 3545 (Aug. 25, 2003), pet. denied, 95 Fed. Appx. 361 (D.C. Cir. 2004); Erik W. Chan, 55 S.E.C. 715, 724-25 (2002).

Dearlove became a cause of Adelphia's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 12b-20 by signing Deloitte's unqualified audit report and certifying that Adelphia's 2000 Financial Statements complied with GAAP, when they did not. Cf. KPMG, 54 S.E.C. at 1173-74.

"Causing" liability for Adelphia's Section 13(b)(2)(A) violation presents a closer question because Dearlove was an outsider. Dearlove did not cause Adelphia to "make" inaccurate books and records. By the time the auditors became involved, the relevant parts of Adelphia's books and records were already inaccurate. As a consequence, Dearlove's position is fundamentally different from that of the corporate insiders found to have caused Section 13(b)(2)(A) violations in Armstrong, McConville, and Yesner. His position is also different from the outside auditor who instructed an issuer's in-house accountant to make improper

[52] The "reasonable assurances" language in Section 13(b)(7) is analogous to the "safe harbor" provision for alleged supervisory failures in Section 15(b)(4)(E) of the Exchange Act. Just because a registered representative of a brokerage firm commits an antifraud violation, it does not necessarily follow that the brokerage firm or its officers failed to provide reasonable supervision to the registered representative. See IFG Network Sec., Inc., __ SEC Docket ___, ___ , Exchange Act Release No. 54127 at 18-19 (July 11, 2006).

accounting entries in Ponce, 54 S.E.C. at 813-14, 825 (finding willful aiding and abetting and causing liability).

As I understand the Division's position, Dearlove signed an unqualified audit opinion letter that permitted Adelphia to "keep" its books and records just as they were before the audit. The post-audit books and records that Adelphia "kept" did not accurately reflect its transactions and disposition of its assets. By signing the audit opinion letter in violation of GAAS, Dearlove engaged in an act or omission that he should have known would contribute to Adelphia's failure to correct its primary violation. Under this logic, Dearlove thus became a cause of Adelphia's continuing violation of Section 13(b)(2)(A) of the Exchange Act.

Dearlove argues that such reasoning stretches the concept of causation to unrecognizable lengths. He should be aware of certain points. First, the Division need not prove that Dearlove was a proximate cause of Adelphia's Section 13(b)(2)(A) violation. See McConville, 85 SEC Docket at 3145-46 n.45; Chan, 55 S.E.C. at 734 ("[T]he mere fact that others also may have caused [a primary violation of] the securities laws does not insulate Chan from liability for his own acts and omissions."). Second, this proceeding is apparently the first contested adjudication to present this specific causation issue. However, the Division's theory of causation is consistent with a series of recent (i.e., post-Enron) settlements in which the Commission found that outside auditors caused issuers' violations of Section 13(b)(2)(A).[53] Third, the Commission has yet to announce the criteria it will use in deciding whether a secondary actor should have known that specific acts or omissions "would contribute to" a primary violation for purposes of Section 21C(a) of the Exchange Act. One administrative proceeding raised that issue, but the Commission dismissed the matter because a majority of the Commission could not agree on a disposition. See Jeffrey M. Steinberg, 76 SEC Docket 1538, 1582-89 (Dec. 20, 2001) (Initial Decision) (rejecting the Division's argument that any act that contributes to a primary violation is a cause of that violation for purposes of Section 21C(a) of the Exchange Act; and also requiring the Division to establish "a sufficient nexus" between the respondents' alleged conduct and the underlying violation), dismissed, 85 SEC Docket 3443 (July 6, 2005); see also Simon M. Lorne & W. Hardy Callcott, Administrative Actions Against Lawyers Before the SEC, 50 Bus. Law. 1293, 1308 (Aug. 1995) ("'Causing' liability under the Remedies Act poses several questions that the SEC has not yet finally resolved. . . . [One question] is the issue of how close a nexus must there be between the 'cause' and the underlying violation.").

I conclude that there is a sufficient nexus between Dearlove's signing the audit opinion and Adelphia's continuing violation of Section 13(b)(2)(A). On that basis, I also conclude that Dearlove caused Adelphia to "keep" books and records in violation of Section 13(b)(2)(A) of the Exchange Act. This conclusion is not significant in the overall context of the case, because a cease-and-desist order is not warranted. See infra pp. 67-69.

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[53] See PKF, Securities Act Release No. 8675 at 15-16 & n.11 (Apr. 12, 2006) (Settlement Order); Michael B. Johnson, CPA, Exchange Act Release No. 53444 at 4 (Mar. 8, 2006) (Settlement Order); John J. Canepa, CPA, 80 SEC Docket 2438, 2446 (July 24, 2003) (Settlement Order). In the absence of an opinion explaining the Commission's reasoning on an issue, settlements are of dubious value as precedent. See Carl L. Shipley, 45 S.E.C. 589, 591-92 n.6 (1974).

Without proof of a primary violation of Section 13(b)(2)(B), there can be no causing liability. This charge is accordingly dismissed.

## MISCELLANEOUS ISSUES

### Witness Credibility

I have addressed the credibility of the principal fact witnesses (Brown, Werth, Caswell, Hofmann, and Dearlove) throughout this decision. I make the following additional findings.

Brown pleaded guilty to criminal charges of conspiracy, securities fraud, and bank fraud in November 2002 (Tr. 83; DX 150 at 54). As part of his plea agreement, Brown agreed to cooperate with the U.S. Attorney and the Division (Tr. 85-86). Three and one-half years later, Brown still has not been sentenced (Tr. 90). Brown is also a defendant in the Commission's civil action against Adelphia. He has consented to an injunction and an officer and director bar, but the issue of financial sanctions remains open (Tr. 86). Werth pleaded guilty to criminal charges of securities fraud and conspiracy to commit securities, wire and bank fraud in January 2003 (Tr. 304-05; DX 150 at 54). As part of his plea agreement, Werth also agreed to cooperate with the U.S. Attorney and the Division (Tr. 307, 311). Three and one-half years later, Werth still has not been sentenced (Tr. 309, 317). Brown and Werth would benefit from favorable sentencing recommendations (Tr. 89-91, 312-13, 317), and Brown would also benefit from an exercise of prosecutorial discretion that quietly eliminates financial sanctions. I have weighed their testimony with these factors in mind. I have disregarded their uncorroborated testimony concerning their impressions of Dearlove and their feelings about his departure from Deloitte.

Caswell settled a Rule 102(e) proceeding, without admitting or denying liability (Tr. 479, 503). William E. Caswell, CPA, 86 SEC Docket 1257 (Sept. 30, 2005). The Commission found that Caswell engaged in improper professional conduct during the 2000 audit. It barred him from appearing and practicing before it as an accountant, with a right to apply for reinstatement after two years. The Division provided Hofmann with an opportunity to make a Wells Submission in October 2003. It has not brought charges against Hofmann (Tr. 761-62). Both witnesses are still employed by Deloitte. I have weighed their testimony with these factors in mind.

Dearlove testified in his own defense for ten and one-half hours and 445 transcript pages. Parts of his testimony were not controversial and I treat them as generally credible. These include the summary of his professional career, his selection as engagement partner for the 2000 audit, his introduction to Deloitte's Pittsburgh office staff, his orientation to Adelphia, and his decision to resign from Deloitte. The least credible parts of Dearlove's testimony were his explanations for the absence of work papers and his rationale for failing to test management's representations in significant audit areas. These explanations lacked detail and were evasive. I treat as hyperbole Dearlove's testimony that the Wink transaction was "probably the most significant audit event" of his career (Tr. 1840).

Lindsey, Rothenberger, and Cass were generally credible witnesses who offered relevant testimony. Hobert and Larry Spirgel were also generally credible witnesses, but they had limited knowledge of matters within the scope of the OIP. Diane Rowe, a character witness for Dearlove, was fully credible.

Macdonald also testified truthfully. However, he did not begin working for Adelphia until 2003, and lacked first-hand knowledge of the matters alleged in the OIP. Despite Macdonald's willingness to explain his own accounting judgments, the Division neither offered nor qualified him as an expert. Macdonald's testimony and DX 150 have limited relevance to the matters presented for decision. See supra pp. 48-49 & nn.17, 42, 50.

Charles Brinley (Brinley), a credit associate in the media and telecommunications credit products group of the Bank of America, testified for the Division (Tr. 1243). Bank of America played a significant role in arranging the 2000 credit agreement, but it played a much more limited role in the 1999 credit agreement (Tr. 1245-46; DX 19 at DT 41841). Brinley's ability to testify with authority about the thinking of each bank that was a member of the 1999 and 2000 lending syndicates was limited. Bank of America did not participate in the 1996 loan, and Brinley did not work for Bank of America until 1998 (Tr. 1243; DX 60 at 117-27).

Biegel gave an inordinate number of "I don't recall" answers to the Division's questions about the specifics of the 2000 audit (Tr. 856, 858-60, 870-75, 877, 880-83, 886-87, 889-92, 894, 896-903, 906, 909, 911, 916-19, 946-47). It was plain that Biegel had no intention of testifying about the audit in a manner that might reflect poorly on himself, Dearlove, or Deloitte. This aspect of Biegel's testimony was not credible. It contrasted with the more detailed and forthcoming testimony of Lindsey.

Savage is a consultant with Tatum Partners and an employee of Adelphia's controller (Tr. 1191, 1210, 1313-14, 1328-29). She was a truthful witness who had the misfortune to appear as a last-minute surprise substitute for a substitute witness. As a result, she walked into a difficult situation that was not of her making.[54]

[54] The Division's witness lists identified Sandra Parrado (Parrado), a PWC Forensic accountant. PWC withheld a large quantity of subpoenaed documents relating to its forensic audit of Adelphia (Tr. 555-75, 711-16, 842-44, 1010-54, 1144-53). The Division elected not to call Parrado because it anticipated that she might invoke various claims of privilege on cross-examination. The Division did not wish to risk a ruling that her testimony might be stricken. Cf. Blizzard, 55 S.E.C. at 760. On January 27, the Division represented that it would call Joseph Sabol (Sabol), an Adelphia staff accountant, as a substitute for Parrado (Tr. 1152, 1302-03). However, on January 30, the Division announced that Sabol was no longer an Adelphia employee and was unavailable (Tr. 1309-10). Without any notice to Dearlove, the Division then offered Savage as a substitute for its substitute (Tr. 1309-11). The prejudice to Dearlove is manifest. On that basis, and pursuant to my authority to regulate the course of the proceeding and the conduct of the parties, see Rule 111(d) of the Commission's Rules of Practice, I decline to consider Savage's testimony or DX 230, the exhibit she created.

Both expert witnesses were well-qualified CPAs and certified fraud examiners. Lesser's direct testimony consisted of a sixty-eight-page written report. He then testified for three hours on cross-examination and two hours on redirect. Dearlove vigorously challenged Lesser's opinions at the hearing and in his brief (Dearlove Br. at 33-39). I found the Division's response to Dearlove's criticisms of its expert to be surprisingly muted. Love's direct testimony consisted of a fifty-eight-page written report. He then testified for twenty minutes on cross-examination and redirect. The Division did not attempt to challenge Love's qualifications, analysis, or opinions. In fact, the Division's cross-examination of Love was limited to largely perfunctory questions and fourteen transcript pages. I have favorably relied on parts of the testimony of both experts. I have rejected other parts of their testimony.

Reconsideration of Rejected Division Exhibits

The Division urges me to reconsider my bench rulings excluding five of its proposed exhibits (Div. Br. at 62-66; Div. Reply Br. at 41). Dearlove responds that the bench rulings were correct and should now be reaffirmed (Dearlove Br. at 186-93).

Rejected Division Exhibits 224A and 224B. The Division offered proposed summary exhibits DX 224A and DX 224B during the redirect examination of its expert witness (Tr. 1552-58, 1576-79). The exhibits relate to pages 31-32 and 35 of Lesser's Report. They compare Adelphia's and Rigas Cable Entities' operating cash flows and balance sheets, using certain data that Lesser omitted from his Report. The Division was not entirely candid in this matter.

The Division first stated that it would use these exhibits only to refresh Lesser's recollection (Tr. 1553). However, it then reversed course and offered them into evidence. Counsel's only explanation: "I changed my mind halfway" (Tr. 1557). The Division argued that the proposed exhibits fell within the permissible scope of redirect examination (Tr. 1557) ("The cross-examination went a lot into this issue of the Rigas managed Entities' ability to pay the debt and the interest on the co-borrowed debt, so the door has been opened.").

First, I reject the Division's expansive understanding of the cross-examination. Dearlove did not cross-examine Lesser about the Rigas Entities' ability to service debt through their operating cash flows, but only about the Rigas Entities' ability to service debt through the sale of subscriber assets (Tr. 1456-57). To the extent that cross-examination even mentioned cash flows, it focused on Lesser's claim that the lending syndicates looked primarily to the co-borrowers' cash flows to satisfy their debt (Tr. 1463-64), and elicited Lesser's concession that the Rigas Entities had "some" cash flow (Tr. 1488).

Second, I reject the Division's assumption that it has nearly limitless remedies if an opposing party "opens the door." See Manuel, 335 F.3d at 597; Bursey, 85 F.3d at 296. The Division cannot offer its proposed exhibits outside the normal order of proof, without a legitimate justification.

Third, my bench ruling causes minimal prejudice to the Division. The attachments to rejected DX 224A and DX 224B are already part of the record as other Division exhibits (Tr. 1555; Rule 351(b) Exhibit List, dated Mar. 22, 2006, at 12).

Fourth, the Division was attempting to gain an unfair advantage over Dearlove. The one-page text of rejected DX 224A and the one-page text of rejected DX 224B represent an impermissible attempt by the Division to embellish and expand on Lesser's direct testimony (Tr. 1577-79). Under the scheduling order applicable to this proceeding, the Division was required to provide Lesser's direct testimony to Dearlove by December 16, 2005. Although a different item in the scheduling order permitted the Division to file summary and demonstrative exhibits by January 10, 2006, that did not mean that the Division could use the device of a summary or demonstrative exhibit to plug the holes in Lesser's direct testimony. See supra n.27. Dearlove's expert did not have sufficient time to respond to these proposed exhibits before he submitted his own direct testimony on January 13, 2006. Accepting these two exhibits would be unfair to Dearlove. I reaffirm my bench ruling to exclude proposed DX 224A and DX 224B.

Rejected Division Exhibits 125, 226A, and 226B. The Division's bank record exhibits (proposed DX 125, DX 226A, DX 226B) were discussed extensively at the hearing (Tr. 1371-81, 1641-56). The Division rested its case without calling a witness to explain the voluminous bank records. A Commission employee apparently prepared summaries of the relevant bank records, but the Division never identified that individual on its witness list as addressing the topic, and it never offered the summaries at the hearing (Tr. 1653-54, 1656; Order of Feb. 27, 2006, at 2-3).

The Division's mishandling of bank records began early in the proceeding. Under Rules 160(a) and 230(d) of the Commission's Rules of Practice, the Division was obliged to make the bank records available to Dearlove for inspection and copying no later than October 17, 2005 (Order of Oct. 14, 2005). It failed to do so. When the Division submitted its exhibit list on December 6, 2005, it described a proposed exhibit as "account statements for the time period between 5/6/99 to 4/30/02 for [four] accounts held at First Union National Bank." It then stated: "Documents are in the process of being reproduced by Wachovia [Bank] in order to replace documents missing from original production." At a prehearing conference the next day, the Division explained that it had not made the bank records available to Dearlove (Prehearing Conference of Dec. 7, 2005, at 21-22) ("we don't have them, but we did have them . . . just in the course of things, it got lost"). The Division estimated it would turn over the bank records to Dearlove in one week.

On December 20, 2005, the Division submitted its revised exhibit list. The revised list contained the same description and the same status report for the still-missing bank records. At a prehearing conference the next day, Dearlove complained that he did not have the bank records (Prehearing Conference of Dec. 21, 2005, at 16-19). The Division explained what the documents would show, and estimated their volume as 2,000 to 3,000 pages.

The Division eventually provided Dearlove with some of the missing bank records on December 29, 2005, and January 3, 2006. After another week, the Division informed Dearlove that it would only rely on bank records of transactions during 2000 (Letter of Jan. 10, 2006, from N. Brown to J. Sedita).

Rejected DX 125 is a list of 627 bank accounts purportedly maintained by Adelphia, its subsidiaries, and the Rigas Entities during 2000. The Division made two representations about

DX 125, both of which turned out to be inaccurate. After initially describing DX 125 as "a non-controversial listing of bank accounts from Adelphia's files" (Tr. 1379), the Division twice asserted that DX 125 is "an Adelphia document" (Tr. 1569; Div. Br. at 64). This is patently incorrect. The document was created by a law firm in May 2002, and it is prominently labeled "attorney work product." The preliminary nature of the document is evident from the fact that the law firm characterized it as a "draft." The Division also asserted that DX 125 listed "all" or "the universe" of the bank accounts maintained by Adelphia, its subsidiaries, and related parties during 2000 (Tr. 1642, 1644). However, upon closer examination, the Division conceded that two of the four bank accounts that are most important to its case were omitted from DX 125 (Tr. 1643-44, 1646). It is understandable that a document prepared in May 2002 might be incomplete. It is not understandable that, almost four years later, the Division would represent that the preliminary draft was reliable and complete. DX 125 is not what it purports to be. If the Division had explanations for these discrepancies, it should have provided a witness who could be cross-examined about them. Therefore, I reaffirm my bench ruling to exclude proposed DX 125 from the record.

The Division described DX 226A as a compilation of records from Wachovia Bank, the successor to First Union National Bank, reflecting draws on the co-borrowing credit agreements by Adelphia and its subsidiaries during 2000 (Tr. 1642-43, 1646-47). However, DX 226A is not what it purports to be, either. The first page of the exhibit is a bank record of Highland Prestige Georgia, a Rigas Entity, but not an Adelphia subsidiary (Tr. 1648). Other pages in DX 226A show deposits made to an account maintained by UCA, an Adelphia subsidiary. However, the UCA account identified in DX 226A (# 879663) is not the account identified in the declaration of the Wachovia Bank employee who provided bank records to the Division and attested to their authenticity (DX 233, identifying account # 789663). Because neither account appears on rejected DX 125, it is unclear if the bank employee's affidavit contained a typographical error or if UCA had multiple accounts. Once again, the Division should have provided a witness who could be cross-examined about these discrepancies.

The Division described DX 226B as a compilation of bank records reflecting disbursements from four accounts of Adelphia and its subsidiaries to various payees during 2000 (Tr. 1372, 1649). Included somewhere among these 406 pages are a few relevant disbursements to Rigas Entities.

The parties were well aware that they could not simply dump a multi-page document into the record when only a portion of the document was relevant to the issues in the OIP (Prehearing Conference of Dec. 7, 2005, at 16). Cf. Del Mar Fin. Servs., Inc., 81 SEC Docket 1691, 1705 & n.22 (Oct. 24, 2003) ("The law judge would have been within her discretion in requiring the Division to specify the specific statements that it was relying on and excluding irrelevant, immaterial, or unduly repetitious evidence under Rule of Practice 320."). Nonetheless, proposed DX 226A consists of eighty-two pages of bank records. The pages are not bound or sequentially numbered, and they are held together only with a metal clamp. Proposed DX 226B consists of 406 pages of bank records. The pages are not bound or sequentially numbered, and they are held together only with a rubber band. The Division made only a token effort to identify those parts of the exhibits that it viewed as relevant to the case, to segregate those parts from the irrelevant bank records, and to offer only the relevant bank records.

When the delay in providing access to the bank records is combined with the discrepancies in the records and their volume, the unfairness to Dearlove is clear. I reaffirm my bench ruling to exclude proposed DX 226A and DX 226B from the record.

Dearlove's Due Process Claims

Dearlove requested me to postpone the start of the hearing for sixty days. The Division opposed any postponement, and I denied Dearlove's motion (Order of Dec. 20, 2005).[55] See Rule 161(b)(1) of the Commission's Rules of Practice (an ALJ shall strongly disfavor extension requests unless the requesting party makes a strong showing that denial of the request would substantially prejudice his case). Dearlove now renews his claim that due process required a sixty-day postponement (Dearlove Br. at 178-85).

The Commission directed the presiding ALJ to issue an initial decision in this matter within 300 days after service of the OIP. See Rule 360(a)(2) of the Commission's Rules of Practice. The schedule here provided 120 days from service of the OIP to the completion of the hearing (Oct. 5, 2005, to Feb. 2, 2006); then eighty-two days to review and correct the hearing transcript, prepare and certify the record index, and file post-hearing pleadings (Feb. 3 to April 25, 2006); then ninety-eight days to prepare and file this Initial Decision (Apr. 26 to Aug. 1, 2006). This schedule complied with the guidelines in Rule 360(a)(2). In fact, it provided the parties more time than anticipated by the Commission's guidelines.

Dearlove's main objection is that he did not have enough time for discovery. It is true that the Division's investigative file was massive. It is also true that Dearlove's hearing preparation was frustrated to some degree by the Division's loss of bank records and its late production of adequate witness and exhibit lists, and by the failure of third parties (Adelphia and PWC) to produce millions of pages of documents in response to his subpoenas.[56]

First, it is well settled that parties have no basic constitutional right to pre-trial discovery in administrative proceedings. See Sims v. NTSB, 662 F.2d 668, 671 (10th Cir. 1981); Silverman v. CFTC, 549 F.2d 28, 33 (7th Cir. 1977); NLRB v. Interboro Contractors, Inc., 432 F.2d 854, 857-58 (2d Cir. 1970). In addition, the Commission's Rules of Practice provide for only limited discovery. Steven E. Muth, 86 SEC Docket 1217, 1238 & n.59 (Oct. 3, 2005).

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[55] The Commission subsequently denied Dearlove's application for interlocutory review, but stated that "the [ALJ's] conclu[sion] that no postponement of the hearing date was warranted . . . will be subject to review, along with other aspects of the [ALJ's] handling of the case, after issuance by the [ALJ] of an initial decision." Gregory M. Dearlove, CPA, Admin. Proc. File No. 3-12064 (Jan. 6, 2006).

[56] Approximately ninety boxes of responsive materials, plus additional electronic files, were withheld from Dearlove on grounds of privilege (Tr. 1144-49). There is no privilege log (Tr. 1148-49).

However, the due process clause of the Constitution and the Administrative Procedure Act do ensure the fundamental fairness of an administrative hearing.

Second, when Dearlove demonstrated that he needed some relief to prepare for the hearing, I ruled in his favor. At Dearlove's request, I required the Division to file an itemized privilege log (Order of Dec. 5, 2005). I also rejected the Division's argument that it had a "right" to assert its claims of privilege one-by-one. I required the Division to amend its deficient witness and exhibit lists (Order of Dec. 9, 2005). To minimize any resulting prejudice, I modified the scheduling order to give Dearlove several additional weeks to identify his proposed exhibits and fact witnesses (Order of Dec. 9, 2005, at 2 n.2). When the Divisions of Corporation Finance and Enforcement opposed Dearlove's document subpoena, I denied their motion to quash in substantial part (Orders of Jan. 9 and 19, 2006). As a result, the Division of Corporation Finance provided Dearlove with ten of fourteen responsive documents. I held four telephonic prehearing conferences to keep the proceeding on schedule.

Third, the delays that Dearlove encountered in obtaining documents from third parties were foreseeable. I strongly encouraged Dearlove to submit his applications for document subpoenas at an early date (Prehearing Conference of Oct. 28, 2005, at 12, 51-52). Nonetheless, Dearlove waited one month to submit his subpoena applications to me. Dearlove's attorney may have acquiesced in the decision of Adelphia and PWC to withhold millions of pages of documents under a claim of privilege (Tr. 563; Letter from Willkie Farr & Gallagher LLP to ALJ, dated Jan. 26, 2006).

Fourth, in preparing this Initial Decision, I have not relied on those aspects of the record that are unfairly prejudicial to Dearlove. See supra nn.31, 35, 54. I have also declined to reconsider my bench rulings rejecting certain of the Division's exhibits. See supra pp. 61-64. Finally, I have declined to entertain the Division's eleventh-hour inclusion of allegations that were not contained in the OIP (e.g., failure to disclose the timber rights and Eleni Interiors transactions, violation of Commission Regulation S-K). See supra pp. 49-51 & n.40.

Dearlove argues that, if denial of a sixty-day postponement of the hearing was proper under the Commission's Rules of Practice, then Rules 161(b)(2) and 360(a)(2) must themselves violate due process (Dearlove Br. at 184). In making this argument, Dearlove echoes some of the public comments submitted in the rulemaking proceeding that led to the adoption of Rule 360(a)(2) in June 2003.[57] However, any claim that the Rules of Practice are unconstitutional must be addressed to the Commission.

I deny Dearlove's claim that the Rules of Practice, as applied in this proceeding, violated due process. I decline to rule on Dearlove's alternative claim that the Rules of Practice, on their

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[57] See Letter from the District of Columbia Bar, Corporation, Finance and Securities Law Section to the Commission (Mar. 21, 2003); Letter from the American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities to the Commission (May 13, 2003) (available at http://www.sec.gov/rules/proposed/s70403.shtml).

face, violate due process. Dearlove is free to renew that claim before the Commission, if he chooses to do so.

## SANCTIONS

### A. Appearing and Practicing Before the Commission

The Commission has long emphasized that Rule 102(e) proceedings are intended to protect the integrity of its processes. Marrie v. SEC, 374 F.3d 1196, 1200 (D.C. Cir. 2004); William R. Carter, 47 S.E.C. 471, 473-74 (1981); Touche Ross & Co. v. SEC, 609 F.2d 570, 579-81 (2d Cir. 1979). The Commission has explained that, in the performance of its statutory duties, it relies heavily on the professionals who appear and practice before it. Touche Ross, 609 F.2d at 579-81. It views Rule 102(e) as a means to ensure that those professionals perform their tasks diligently and with a reasonable degree of competence. Id. The Commission has insisted that it does not use Rule 102(e) as an additional weapon in its enforcement arsenal. Id. The bright-line distinction between disciplinary proceedings and enforcement proceedings is also memorialized in Rules 101(a)(3)-(4) of the Commission's Rules of Practice.

Under Rule 102(e)(1)(ii), the Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it to any person who is found to have engaged in improper professional conduct. The Division argues that Dearlove should be denied permanently the privilege of appearing or practicing before the Commission.

The Commission may impose sanctions under Rule 102(e) for a remedial purpose, but not for punishment. McCurdy v. SEC, 396 F.3d 1258, 1264 (D.C. Cir. 2005). Reviewing courts have upheld Rule 102(e) sanctions if they protect the public from future improper professional misconduct by professionals who practice before the Commission. Id.; Ponce, 345 F.3d at 741.

Deloitte identified specific risks when it planned the audit of Adelphia's 2000 Financial Statements. Dearlove, a very experienced auditor, failed to conduct and supervise the audit to address those risks. He also failed to insist on the appropriate disclosures mandated by GAAP with respect to Adelphia's debt and related-party transactions. As a result, Dearlove engaged in repeated instances of unreasonable conduct. Each resulted in a violation of applicable professional standards, and each indicates a lack of competence to practice before the Commission. Dearlove also engaged in a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which he knew that heightened scrutiny was warranted. The violations of applicable professional standards were extremely serious, and material misstatements appeared throughout Adelphia's 2000 Financial Statements. Dearlove has not offered any assurances against future violations, fails to recognize the wrongful nature of his conduct, and continues to insist that he acted appropriately.

Dearlove has been married for thirty years; he and his wife have three children, ages twenty-two, nineteen, and fifteen (Tr. 1720-21). Dearlove has been active in civic and charitable activities in the Buffalo area (Tr. 1729). He has a reputation for integrity and is respected in his community (Tr. 2052). Dearlove has served on the local boards of directors of the American Heart Association and Ronald McDonald House (Tr. 1729-31). He has also been active as a

board member of Hilbert College in Hamburg, New York, and the Boys and Girls Clubs of Buffalo (Tr. 1729-31, 2044-53). Apart from the present proceeding, Dearlove has not been the subject of any professional investigation or disciplinary action (Tr. 1925-26). He has never been the subject of a civil lawsuit or charged with a crime (Tr. 1926).

I have not given controlling weight to this evidence of good character. It was a poor predictor of the likelihood that Dearlove would engage in improper professional conduct in the first instance, and it cannot be assumed to be an accurate predictor that he represents no future threat to the integrity of the Commission's processes. Cf. In re Walter, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,215 at 35,014 n.19 (1988) ("[A] history of civic achievement or charitable associations does not mitigate a disqualification that arose despite the existence of this evidence of 'good character.'"); In re Horn, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,731 at 33,889-90 (1987) ("Absent evidence that the wrongful conduct arose from peculiar circumstances that have no substantial likelihood of recurrence, . . . the weight that might normally be accorded evidence of a history of good conduct is simply eviscerated by the subsequent wrongful conduct.") (footnote omitted). I have given more weight to the fact that Dearlove did not provide credible explanations for the absence of work papers and the failure to test management's representations in significant audit areas. Cf. Ahmed Mohamed Soliman, 52 S.E.C. 227, 230-31 (1995).

I conclude that Dearlove engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice. I further conclude that he should be denied the privilege of appearing and practicing before the Commission.[58]

**B. Cease-and-Desist Order**

Nothing in Rule 102(e) indicates that it is the exclusive means for the Commission to address accountants' conduct. KPMG, LLP v. SEC, 289 F.3d 109, 119 (D.C. Cir. 2002). The Division argues that Dearlove should not only be barred under Rule 102(e), but also should be ordered to cease and desist from causing violations or future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 13a-1 and 12b-20 thereunder.

In relevant part, Section 21C(a) of the Exchange Act authorizes the Commission to impose a cease-and-desist order upon any person who "is, was, or would be a cause of [a] violation" due to an act or omission the person "knew or should have known would contribute to such violation."[59]

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[58] Dearlove elected to litigate the Rule 102(e) sanction on an all-or-nothing basis. For example, he did not argue that a bar should be limited to a fixed term, or to appearing and practicing "as an accountant." In these circumstances, I grant the Division the full relief it sought.

[59] Dearlove can be a cause of Adelphia's primary violations, but he cannot directly commit violations of provisions that apply only to issuers. Cf. Gateway Int'l Holdings, Inc., __ SEC Docket ___, ___ n.51, Exchange Act Release No. 53709 at 17 n.51 (May 31, 2006).

In KPMG, 54 S.E.C. at 1183-92, the Commission addressed the standards for issuing cease-and-desist relief. It explained that the Division must show some risk of future violations. However, it also ruled that such a showing should be "significantly less than that required for an injunction" and that, absent evidence to the contrary, a single past violation ordinarily suffices to raise a sufficient risk of future violations. Id. at 1185, 1191.

Along with the risk of future violations, the Commission considers the seriousness of the violations, the isolated or recurrent nature of the violations, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. Id. at 1192. In addition, the Commission considers whether the violations are recent, the degree of harm to investors or the marketplace resulting from the violations, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceeding. Id. The Commission weighs these factors in light of the entire record, and no one factor is dispositive.

The U.S. Court of Appeals for the District of Columbia Circuit has insisted that the Commission adhere to the standards it announced in KPMG. See WHX Corp. v. SEC, 362 F.3d 854, 859-60 (D.C. Cir. 2004) (rejecting the Commission's explanation of the risk of future violations and vacating a cease-and-desist order).

Several of the KPMG factors support a cease-and-desist order here. Adelphia's violations, for which Dearlove was a cause, were extremely serious. The violations permeated the entirety of Adelphia's 2000 Financial Statements. Dearlove has not offered any assurances against causing future violations. He fails to recognize the wrongful nature of his conduct and continues to insist that he acted appropriately. The harm to investors and the marketplace when an issuer misrepresents its financial condition cannot be overstated. SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1377 (D.C. Cir. 1980); McConville, 85 SEC Docket at 3152 & n.67; Armstrong, 85 SEC Docket at 3040 & n.89. Investors who buy or sell stock based on the erroneous information are harmed greatly.

However, other KPMG factors do not support a cease-and-desist order. Dearlove was involved with Adelphia for a single audit year. Adelphia's violations, as caused by Dearlove, occurred more than five years ago. The public has been aware of the violations for more than four years. A cease-and-desist order would proscribe conduct that causes future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and related Exchange Act rules. The prospect that Dearlove could cause future violations of these provisions is minimal. There is no evidence that Dearlove audited any public companies after resigning from Deloitte in September 2001. Dearlove relinquished his position as chief financial officer of a publicly traded company in October 2005. See supra n.12. There is no evidence that he has been involved with GAAP, financial reporting, or record keeping since then.

Finally, KPMG requires decision makers to consider the need for a cease-and-desist order in the context of the other sanctions sought in the proceeding. The Division's case for a cease-and-desist order also founders here. The Commission has interpreted the concept of "practicing before the Commission" broadly. See Armstrong, 85 SEC Docket at 3031-34 (construing Rule

102(f)). Because of the Rule 102(e) practice bar already imposed, Dearlove cannot return to his former position as chief financial officer of a publicly traded company. Nor can he serve in any position where he might cause future violations of Sections 13(a) or 13(b)(2)(A) of the Exchange Act. In guarded language, the Division tacitly concedes that Dearlove's current position does not present a realistic opportunity for him to cause future violations (Div. Br. at 60) ("If Dearlove resumes his service as the [chief financial officer] of a public company, the opportunity for future violations is certain and the risk that they may occur is great.") (emphasis added). Under the Armstrong interpretation, there is nothing that a cease-and-desist order could accomplish in this proceeding that has not already been covered by the Rule 102(e) bar.[60]

The result would be different if I had ordered the most limited form of relief under Rule 102(e), an order of censure. The result would also be different if the cease-and-desist order involved primary liability, rather than causing liability.

The fact that Dearlove may apply for reinstatement "at any time" under Rule 102(e)(5) of the Commission's Rules of Practice does not change the analysis. The Commission can always deny an application for reinstatement, or to attach conditions to its approval, if it believes there is a likelihood of future violations. Conversely, the factors that would persuade the Commission to grant reinstatement would reinforce the conclusion that a cease-and-desist order was no longer needed. Thus, the Division cannot justify a cease-and-desist order as a fail-safe precaution that would remain in effect if reinstatement were to be granted in the future.

After weighing all the relevant considerations, I conclude that a cease-and-desist order would merely duplicate the Rule 102(e) bar, and I decline to issue it.[61]

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[60] In one proceeding that pre-dated KPMG, the Commission imposed both a Rule 102(e) practice bar and a cease-and-desist order. See Ponce, 54 S.E.C. at 820, 825. The Commission reasoned that a cease-and-desist order was appropriate because the respondent could still participate in the review of or preparation of a company's books or its periodic filings, even though his CPA license had lapsed. See id. at 825. However, the Commission has now declared that such activities fall within its definition of "practicing before the Commission." See Armstrong, 85 SEC Docket at 3031-34. As a result, the reasoning of Ponce is no longer controlling on this issue.

The present proceeding is also distinguishable from Harrison Sec., Inc., 83 SEC Docket 2986, 3047 (Sept. 21, 2004), final, 84 SEC Docket 117 (Oct. 29, 2004). The Initial Decision in Harrison barred a respondent from appearing and practicing before the Commission "as an accountant." It also imposed a cease-and-desist order proscribing future violations of an antifraud provision. In the present proceeding, Dearlove is barred from appearing and practicing in any capacity, and not simply "as an accountant." Like Ponce, Harrison was decided before the Commission issued Armstrong. It is distinguishable on that basis, as well.

Based on the magnitude of the improper professional conduct proven here, I conclude that a permanent bar is more appropriate than a cease-and-desist order.

[61] In the past five years, the Commission has considered three contested adjudicatory proceedings in which the Division sought both a Rule 102(e) practice bar and a cease-and-desist

**C. Disgorgement**

As a final sanction, the Division contends that Dearlove should be required to disgorge all compensation attributable to the time he devoted to the Adelphia account. It estimates this amount as $144,253.

Section 21C(e) of the Exchange Act provides that the Commission may enter an order requiring disgorgement, including reasonable interest, in any proceeding instituted pursuant to Section 21C(a).[62] Disgorgement seeks to deprive a wrongdoer of ill-gotten gains. SEC v. First City Fin. Corp., 890 F.2d 1215, 1230-32 (D.C. Cir. 1989). It returns a violator to where he would have been absent the violations. An order to disgorge a certain amount need only be a reasonable approximation of the profits causally connected to the violation. Id. at 1231.

The Division must first show that its disgorgement figure reasonably approximates the amount of unjust enrichment. Once it has done so, the burden of going forward shifts to the respondent to demonstrate clearly that the Division's disgorgement figure is not a reasonable approximation. SEC v. Lorin, 76 F.3d 458, 462 (2d Cir. 1996); SEC v. Patel, 61 F.3d 137, 140 (2d Cir. 1995). Any risk of uncertainty as to the disgorgement amount falls on the wrongdoer whose illegal conduct created the uncertainty. First City, 890 F.2d at 1232.

From the outset, the Division knew that the Commission had recently reversed an ALJ's order to disgorge salary in another proceeding (Prehearing Conference of Oct. 28, 2005, at 33-35). See McConville, 85 SEC Docket at 3151 n.64. With full knowledge of McConville, the Division made only a perfunctory effort to show that Dearlove should disgorge anything at all.

First, Dearlove is not himself a violator of the federal securities laws. He is a cause of Adelphia's violations. The Division does not believe that Dearlove fully earned his salary. As a result, the Division's request for disgorgement seeks to expand the boundaries of what has previously been found to constitute "unjust enrichment" or "ill-gotten gains." But cf. Kenneth L. Lucas, 51 S.E.C. 1041, 1046-47 (1994) (reversing an NASD disgorgement order against supervisors and noting, among other things, that officials who had failed to supervise were not primary violators).[63]

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order against an accountant. In all three cases, the Commission granted only one of the proposed sanctions. See Armstrong, 85 SEC Docket at 3038-42; Philip L. Pascale, CPA, 85 SEC Docket 2, 22-23 & n.40 (Mar. 18, 2005); KPMG, 54 S.E.C. at 1166, 1183; see also Yesner, 75 SEC Docket at 269-70 (ALJ imposed a cease-and-desist order, but not a Rule 102(e) bar).

[62] Denial of the requested cease-and-desist order does not preclude disgorgement in this proceeding.

[63] I am not aware of any contested adjudicatory proceedings in which the Commission has ordered disgorgement by an individual who caused a violation, but did not also commit a violation or willfully aid and abet a violation. One settled matter fits this description, but it is distinguishable from the present proceeding because the auditor received his fee directly from

Second, Dearlove received compensation from Deloitte, not from Adelphia. The Division has not shown that Dearlove's compensation was causally connected to Deloitte's audit of Adelphia's 2000 Financial Statements. There is no evidence that Deloitte paid Dearlove a bonus or any other incentive-based compensation for working on the Adelphia audit. Nor is there evidence that Deloitte would have reduced Dearlove's compensation if he had not worked on the Adelphia audit.

Third, the Division's principal disgorgement exhibits, DX 146 and DX 232, are unreliable. The Division presented the declaration of Stephen J. Coulter (Coulter), a Deloitte partner who is familiar with the firm's records (DX 232). In relevant part, Coulter stated that the documents listed on ("or attached to") Exhibit E of his declaration are true and correct copies of time records Deloitte maintains in the ordinary course of its business (DX 232 ¶ 7). Coulter also stated that the documents attached to Exhibit E had been redacted to remove information relating to Deloitte clients other than Adelphia (DX 232 ¶ 8).

The Division did not offer Coulter's original declaration. There is only a facsimile copy of Coulter's four-page declaration in the record, and it is easily identified by the facsimile trailer at the top of each page. The first five pages attached to Coulter's declaration, identified as Exhibits A through E, do not bear any facsimile trailer. Exhibit E to Coulter's declaration lists Bates-stamped pages DT 984675 through DT 984756 (a total of eighty-two pages). However, the seventeen pages attached to Exhibit E of Coulter's declaration do not contain any Bates-stamps. It is evident that DX 232 is a cut-and-paste document that the Division assembled in at least three different parts, and that the substance of Exhibit E differs from what Coulter described in his declaration. The same observations apply to DX 146, which simply reproduces the seventeen pages of Exhibit E to Coulter's declaration.

The Division provided similar documents in an Appendix to its Prehearing Brief. There, the Division represented that Exhibit B to its Appendix included billing information produced by Deloitte on a compact disc. It also represented that the compact disc had been reformatted to segregate the hours that Dearlove devoted to Adelphia from the hours he devoted to other Deloitte clients. The Division identified the compact disc as Bates-stamped document DT 984757—a document outside the range of pages identified in Exhibit E to Coulter's declaration. The reformatted data in Exhibit B to the Division's Prehearing Brief are presented on a spreadsheet labeled "SEC Work Product." The Division did not offer a declaration or live testimony from the individual who performed the reformatting. Because of these discrepancies, I have given very limited weight to the Division's evidence.

Fourth, the Division may be engaged in impermissible double counting. The April 26, 2005, Settlement Order in Administrative Proceeding No. 3-11910 explains that Deloitte paid $25 million to a victims' restitution fund. The ambiguous wording of the Settlement Order makes it impossible for the reader to know whether that $25 million included Deloitte's audit fee of $1,319,000. See supra n.15. Presumably, Deloitte's $25 million payment was a "gift" that the

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the audit client, not salary from a CPA firm. See J. Allen Seymour, CPA, 75 SEC Docket 800 (June 21, 2001) (settled proceeding).

Commission was "authorized to accept" under Section 308(b) of the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7246(b), although the Settlement Order is ambiguous about that, too. On the one hand, if Deloitte has already disgorged the audit fees that Adelphia paid to it, the Division ordinarily could not collect the same money again from Dearlove. Cf. SEC v. AbsoluteFuture.com, 393 F.3d 94, 97 (2d Cir. 2004); SEC v. Palmisano, 135 F.3d 860, 863-64 (2d Cir. 1998); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996). On the other hand, if the Commission settled Administrative Proceeding No. 3-11910 without requiring Deloitte to disgorge the audit fees that Adelphia paid to it, then it would be inequitable to require Dearlove to disgorge his compensation from Deloitte.

Fifth, even if these other concerns could be eliminated, the Division's computation methodology is seriously flawed. As a result, the Division's estimate of Dearlove's compensation would have to be cut substantially before disgorgement could be ordered. The Division estimates that Dearlove billed 1,045 hours to Adelphia matters during 1999, 2000, and 2001 (Div. Prehearing Br., Ex. A). In contrast, Dearlove estimates that he devoted approximately 710 hours to the 2000 audit (Love Report at 12 & n.11).

The Division's higher estimate includes time that had nothing to do with the audit of Adelphia's 2000 Financial Statements. For example, the Division's calculations demonstrate that Dearlove devoted seventy-four hours to Adelphia matters between November 13, 1999, and April 1, 2000. During this period, Dearlove was learning about Adelphia by shadowing Cottrill, reviewing work papers related to the 1999 audit of FrontierVision, and otherwise assisting in the audit of Adelphia's 1999 Financial Statements. Dearlove's handling of these matters is not challenged in the OIP. There is no basis for assuming that such compensation was ill-gotten. Dearlove should not be required to disgorge compensation he may have earned in connection with these other matters.

The Division's higher estimate also includes another 381 hours that Dearlove devoted to Adelphia matters between March 31 and October 6, 2001. By then, Deloitte had already certified the financial statements that are the subject of the OIP. The offense was complete. During this six-month interval in mid-2001, Dearlove participated in quarterly reviews for the first and second quarters of 2001, answered inquiries from Deloitte's internal practice review team (June 2001), and worked on the Arahova restatement (August 2001). These matters are likewise beyond the scope of the OIP. Dearlove should not be required to disgorge compensation he may have earned in connection with them.

Dearlove's estimate of 710 hours provides a far more accurate starting point than the Division's estimate of 1,045 hours. However, even Dearlove's estimate represents a ceiling, not a floor. It includes time he devoted to the audit of Adelphia subsidiaries whose financial statements were not challenged in the OIP.[64] Disgorgement is not appropriate for compensation Dearlove may have earned in connection with such matters.

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[64] Deloitte required its auditors to report their billable time by using prefixes, such as ADE0266 for Adelphia Business Solutions, Inc. (RX 127, Tab 59). Many of the entries on Dearlove's time logs used the prefixes ADE0266 and ADE03. Billable hours with these specific prefixes have

Based on these factors and in the exercise of my discretion, I decline to require Dearlove to disgorge any of the compensation he received from Deloitte.

## RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on April 5, 2006.

## ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED THAT, pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice, Gregory M. Dearlove, CPA, is denied the privilege of appearing and practicing before the Commission.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision pursuant to Rule 111 of the Commission's Rules of Practice. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the order resolving such motion to correct a manifest error of fact.

This Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact, or unless the Commission determines on its own initiative to review this Initial Decision as to any party. If any of these events occur, the Initial Decision shall not become final as to that party.

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James T. Kelly
Administrative Law Judge

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not been shown to involve conduct that caused any securities law violations. Thus, any resulting "gains" have not been shown to be "ill-gotten" and are not subject to disgorgement.