Spring 2016

Related Parties: Audit Risk When 63 Entities Act as One

Alyssa Lieb
The University of Akron, arl56@zips.uakron.edu

Related Parties: Audit Risk When 63 Entities Act As One

INTRODUCTION

With heightened awareness that fraudulent financial reporting may be more prevalent than ever expected after globally damaging scandals such as Enron and WorldCom, Adelphia Communications emerged from the year 2001 seemingly unscathed. Despite an unqualified audit report from one of the world's most dominant public accounting firms, Adelphia had fraudulent activity pouring from almost every operational aspect of the company. Seemingly standing tall as the then sixth-largest cable company with operations in over 32 states and Puerto Rico, the then soon to be scandal would be about more than refusing to disclose subsidiary debt on consolidated financial statements (Barlaup, Dronen, & Stuart, 2009). Far worse, the root of a $2.6 billion debt concealment, falsified earnings, and fictional operational statistics began and ended with a family corrupted by a desire for frivolous spending furnished by seemingly endless company cash reserves rationalized with promises of repayment (Johnson & Rudolph, 2007). Much like the Rigas family's later attempts at emotional retribution, these initial promises of repayment were nothing but empty. Although it would be easy to place blame on a family clearly involved in precarious practices, shareholders, as well as the SEC, believed the issue infiltrated well beyond the company and rooted itself into the heart of one of the nation's forefront public accounting firms, Deloitte.

COMPANY BACKGROUND

For John Rigas, family and business were never separately compartmentalized affairs. Adelphia, Greek for *adelphos*, meaning brother, began innocently enough with John Rigas and two partners. Rigas later bought out the partners and expanded the venture along with his brother Gus, purchasing cable systems as early as 1952 across the country on the foundation of heavy loans (Grover & Lowry, 2002). For 34 years, the Rigas' carried out operations solely as a family affair before choosing to reorganize five cable television ventures and create the publicly traded corporation, Adelphia Communications (Barlaup et al., 2009). In 2001, the idea of a "family environment" was still a focal point with Rigas family members involved in numerous upper-level executive positions throughout the company. Rigas sat as the head of the board of directors, which also featured his three sons and son-in-law as dominant decision makers destined to decide the company's ill-seated fate (Grover & Lowry, 2002). The Rigas family owned or vastly controlled some 63 other entities including various partnerships, corporations, and limited liability companies. Although some were within the realm of cable television providers, 49 of these other Rigas entities involved widely differentiated interests such as the Buffalo Sabres hockey franchise, film production studios, and Christmas tree farming outfits (Johnson & Rudolph, 2007). Family ties ran even deeper with Adelphia renting trucks, equipment, and even its office headquarters from various Rigas entities until as recently as 2000 (Grover & Lowry, 2002).

In further investigation as to the root of the initial fraud, many pinpoint a two-year span of mass acquisitions designed to help Adelphia adequately stay on par with its competitors as the final piece needed to spur the company towards cataclysmic ruination. From early 1999 to the end of 2000, Adelphia paved its road to destruction by amassing over $12.6 billion in debt. With new holdings that radically doubled the size of the company, its total liabilities skyrocketed 3.6 times from the once potentially manageable $3.5 billion (Johnson & Rudolph, 2007). Although Adelphia's co-borrowing debt listings should have appeared on consolidated financial statements at over $2.6 billion, the financial health of the company appeared strong with the reassurance of its aggressive, risk-taking founder continuing to maintain the Rigas standard of an opulently lavish lifestyle. This continuation of such a lifestyle seemed to give the appearance that the company was experiencing growth and prosperity; otherwise, the family would have understandably changed their habits had the financial status not been as positive. Despite such an upward spike of corporate debt financing, Adelphia financial statements still reassured investors, and Wall Street, of over $2.9 billion in revenue in 2001 alone, furnished by over 5,547,690 subscribers. Investors would soon find that the company's revenues were also fraudulently inflated to help maintain the appearance of success set forth by a family willing to spend so freely on the company's dime (Barlaup et al., 2009).

ADELPHIA'S FRAUD

In the initial SEC complaint against Adelphia, the company's vast fraud is outlined in harrowing details that include, "Systematic and fraudulent exclusion of billions of dollars in liabilities from its consolidated financial statements,…inflated earnings to meet Wall Street expectations, falsified operations statistics, and concealed blatant self-dealing by…the Rigas family," (The SEC, 2002). Regardless of whether the details of the fraud are placed under the microscope of standards today or those of 2002 when the fraud became public knowledge, every single aspect on its own is a blatant disregard for the very foundations upon which truthful and accurate financial reporting stand. On March 27, 2002, Adelphia publically revealed the first of many financial reporting faux pas in its myriad of deceptive and outright illegal activities. The company confessed to concealing $2.6 billion in liabilities over the course of 1999-2001 (Johnson & Rudolph, 2007). Coming as a surprise to none, Adelphia stock values plummeted over 46% in the month immediately following the company's disclosure. The news of such deception is never well received, but especially when accompanied by the knowledge that the $2.6 billion originated through Adelphia's co-signing of loans for other Rigas family entities unrelated to the parent company's interests (Grover & Lowry, 2002).

Heavily pressured to produce revenues within the realm of its top-producing competitors, Adelphia's earnings before interest, taxes, depreciation, and amortization (EBITDA) was grossly inflated, largely through sham transactions with Rigas family entities that aided in increasing revenues through creation of fake intercompany receivables for the parent company. The falsified transactions were not without fabricated corporate documents (Johnson & Rudolph, 2007) originating from upper-level executives including Vice President of Finance, James Brown and Vice President/Assistant Treasurer, Michael Mulcahey, who were also included in the SEC case against the Rigas family ("Lit release 17627", 2002). Expenses including every-day service calls were capitalized instead of being treated as the ordinary expenses that they were, thus changing the outlook of Adelphia's financial statements to reflect inflated revenues because of improper expense treatments (Leonard et al., 2002).

In order to appease Wall Street even more, operational statistics including efficiency and profit ratios were altered to elude the appearance of more successful operations than what actually existed. In testimony at trial, Brown relayed how fabrication and lying quickly became a part of Adelphia's corporate culture dating as far back as to its first days a publically listed company. He also conveyed the extreme measures the company underwent to maintain its fraudulent ways, admitting that "two sets of books, one showing the reports that Adelphia made to its lenders, and the other identifying what statistics had been manipulated," were kept for over ten years (Barlaup et al., 2009). Adelphia was also found guilty of falsifying its total number of basic cable subscribers by erroneously including those who received various other services such as high-speed internet and security systems. Although this number totaled only 1.1% or 60,000 of the company's subscribers, the goal of masking Adelphia's true financial nature and performance was easily achieved through such a thick web of deceit (Solomon, Frank, & Markon, 2002).

Not So Consolidated Financials

Such a danger always exists when parent companies involve subsidiaries in inter-company transactions, with Adelphia raising more than one red flag during its tumultuous financial mogul tenure. The concealment of $2.6 billion of parent debt shielded from financial statements began with Adelphia subsidiaries and Rigas entities entering into co-borrowing agreements from various lenders, with each borrower individually given access to up to the entire agreement amount of available credit. Although each entity was mutually and independently liable for the sum of all debt, Adelphia chose to use these co-borrowing agreements to its advantage. Being the parent company, Adelphia is required under generally accepted accounting principles (GAAP) to include any subsidiary debt by various Rigas family entities as a part of the parent company's consolidated debt (Johnson & Rudolph, 2007). Management of public companies is charged with preparing financial statements that fairly and accurately reflect the financial standing of the company's accounts, an important standard that the Rigas family failed to uphold with Adelphia statement filings (The AICPA, 2006). Not only did the debt of its subsidiaries fail to appear as a part of the parent company's total liabilities, but the Rigas family further manipulated the consolidated financial statement system by using its subsidiaries to its outright illegal advantage. The $2.6 billion liability carrying value on Adelphia's books quickly dwindled as the company appeared to be paying off its debt in a timely manner. Rather than actually paying off its debts, Adelphia transferred debt from its books and reclassified varying amounts on to the financials of its subsidiaries through a system of endless journal entries that were conveniently difficult to follow. Because Adelphia and its subsidiaries were co-borrowers, the debts should have appeared on the parent company's books as well because it assumes debts of its subsidiaries when consolidated financial statements are produced. Adelphia's blatant disregard for reporting standards thus caused its subsidiaries to perform the same practices to maintain the vast system of fraudulent journal entries from their side of the transactions.

The true nature behind reclassifications of such vast amounts of debt originated through "a single quarterly cash management reconciliation of the inter-company receivables and payables…between Adelphia, its subsidiaries, and Rigas entities," (Johnson & Rudolph, 2007). The corporation's cash management system (CMS) was easily accessible with no monetary limit in place, frequently being used as a system of endless cash flow. The debt was assumed by Rigas enterprises by use of the quarterly reconciliations, achieving reclassification through fraudulent journal entries. The endless trail between parent, subsidiaries, and other Rigas entities made it impossible to tie-down and accurately determine the drawdown of loans pertained to each specific entity carrying the liability on its books. Adelphia helped the cause further by writing off the debts to its subsidiaries, thus championing the "out of sight, out of mind principal," allowing the co-borrowing involvements to be all but forgotten from the parent company's perspective. Adelphia attempted to shield itself from investigation into the disappearing debt by providing footnote disclosures on the consolidated financial statements alluding to the inclusion of Rigas entity debts appearing in Adelphia's liability accounts. This inclusion led to millions of investors feeling comfortable with the company's activities because they lacked knowledge of what was truly taking place.

Self-Dealing Damage

While Adelphia was seemingly paying off its debts, unbeknownst to most through use of its CMS, the Rigas family continued to damage the financials and ethical integrity of the company and the interrelated entities. Because of its centralized nature, the CMS was the ultimate causation of the fraud. The system acted as a joint holding account for Adelphia, its subsidiaries, and other Rigas family operations, allowing family members within each company unlimited access as authorized personnel. The limit on deposits and withdrawals was nonexistent, and this suited the Rigas' quest to use the companies for their own personal gain. Cash flowed freely into the system from credit drawdowns available through the co-borrowings of parent and subsidiaries, unrecorded and virtually nonexistent to any outside party (Johnson & Rudolph, 2007). Because of the lack of monitoring and need to rationalize every dollar that entered and exited the system, the CMS soon became a "personal piggy bank" for members of the Rigas family. Through its acquisitions of enterprises in widely varying industries, along with tastes for extravagant living and frivolous ventures, the Rigas family had amassed over $241 million in personal debt. With family members having unlimited access to the CMS, this personal debt was effectively paid off over the course of several years with countless transfers of millions of dollars to the family members' own bank accounts. Luxury properties purchased across the United States by Adelphia provided private, exclusive access for the Rigas family to get away from corporate operations in Coudersport, Pennsylvania to places such as Colorado, New Mexico, and New York. Used to a private, lavish lifestyle, John Rigas utilized $12.8 million in company funds to build an elaborate golf course and clubhouse on private property controlled by the family ("Personal piggy bank", 2002). Rigas would later claim the golf course was built with every intention of fostering improved public relations as well as offering public use (Barlaup et al., 2009).

When the Rigas family made these withdrawals, none were publically disclosed at the time of transaction, nor was it common knowledge among Adelphia's board of directors, except to those Rigas family members sitting on the board who were privy to such actions (Johnson & Rudolph, 2007). The company also issued notes and stock totaling over $1.3 billion for the direct benefit of the Rigas family ("Personal piggy bank", 2002). Continually concerned with capitalizing from the company's healthy Wall Street returns, Rigas family members used millions from the CMS to purchase company securities, albeit the public was led to believe these capital purchases were supposedly made with personal funds. The most glaring issue in the Rigas' unlimited access to what should have been off-limit funds is the absence of any contractual obligation to repay the withdrawn monies. There existed a complete lack of financial solvency by any family member. Even if a repayment plan had existed, the family's insolvency would have prevented any such system from being effective (Johnson & Rudolph, 2007). All of this culminated into what would be at the time “one of the most extensive financial frauds ever to take place at a public company,” (“Lit release 17627”, 2002).

Cable Industry Powerhouse No More

Beginning with the March 27, 2002, revelation of the concealment of $2.6 billion in corporate debt, Adelphia and its Rigas family counterparts quickly fell from the position of one of the top power players within the cable industry. Financial statements released for fiscal year 2001 included the footnote about Adelphia’s co-borrowing debts that led to further investigation into its financial dealings, claiming that the company was liable for loans to the Rigas family not found on the parent’s balance sheet (Leonard et al., 2002). These co-borrowings had been written off to the company’s subsidiaries and various Rigas entities through the system of fraudulent journal entries, which is why the co-borrowing debt did not appear on Adelphia’s financial statements. Coupled with the footnote fiasco was the filing of Adelphia’s subsidiary, Adelphia Business Solutions, for Chapter 11 bankruptcy on March 27 as well. The company would further hamper its clean image by notifying the public it would delay filing of annual reports with the SEC. At the time, the newly recent discovery of Enron’s off-balance-sheet debt dealings and massive fraud meant even just a simple footnote disclosure lacking a thorough explanation would not be ignored as just a small concern. The combination of issues proved a fatal blow, quickly spurring the SEC to open an informal inquiry into Adelphia’s accounting procedures on April 2, 2002 (Barlaup et al., 2009). At this point, John Rigas, Chairman of the Board of Directors and still CEO of Adelphia, released a string of statements announcing restatement of 1999-2001 earnings. These statements included an acknowledgement that shareholders and investors were now asking for a more in-depth look into the strange financial situations barely brought to light within the most recent footnote disclosures (Leonard et al., 2002). To make matters worse, forensic accountants hired by Adelphia’s independent directors easily uncovered an $175 million withdrawal had taken place even after the March 27 revelation, which was supposedly used to cover Rigas family margin loans (“Personal piggy bank”, 2002). By April 16, Adelphia missed the second filing deadline for its annual report, spurred by heated disagreements between Adelphia and its auditor, Deloitte. Not long after the SEC investigation began, Rigas stepped down as CEO and Chairman on May 15, with his sons following suit only a few days later ("Lit release 17627", 2002). Adelphia's reign as a cable industry mogul came to an end when the company officially filed for Chapter 11 bankruptcy protection on June 25, having finally purged its operations of the Rigas family, but unfortunately not its accounting records (Barlaup et al., 2009).

Deloitte's Nightmare

Auditing of any public company can prove difficult with the audit draining time, money, and resources, even if fraud is not found. For Deloitte, the difficulty in auditing a high profile client was not a sudden development. The firm struggled for years with the Rigas family and the mess of financial statements the family's actions created, often causing disagreements between Deloitte auditors and Adelphia officials over the company's refusal to disclose information to the public regarding its co-borrowing agreements (Barlaup et al., 2009). During the audit of fiscal year 2000, Deloitte urged Adelphia to disclose a co-borrowing footnote. This footnote disclosure did not appear until the following year, and would spark the beginning to the end of the Rigas family's corrupt ways. When the company refused to include the footnote on its co-borrowings on fiscal year 2000 consolidated financial statements, the accounting firm surrendered to management's arguments that the disclosure was unnecessary (Barlaup et al., 2009). An auditor's mission is to protect the interests of shareholders and other third-party members from falsified or misleading financial statements and to provide reasonable assurance that there are no material misstatements. By acquiescing to management rifled with Rigas family members, Deloitte's auditors did not properly perform its audit of Adelphia's financial statements, and thus failed as accounting professionals.

During the course of an engagement, auditors should be looking to continually communicate with those charged with governance, but in the case of Adelphia, the firm was met with Rigas family members determined to keep fraudulent practices from reaching public light. Corrupt son and financial director Tim Rigas made up one of a few members of an audit committee that failed to meet more than once during

1999 and still only a paltry four times during 2000. Research by Barlaup, Dronen, and Stuart (2009) provides that audit committees of most other companies similar in size to Adelphia met an average of at least eight to nine times per year, further shedding light on the company's management and corporate governance flaws. A potential financial reporting ally for Deloitte in Adelphia's audit committee was all but nonexistent when during the final months of 2000 and through April 2001, the committee consisted of only Tim Rigas and one other outside director. Once the SEC began to indict Rigas family members in September of 2002, Adelphia began to take up any means of defense that could turn even the slightest shred of guilt on anyone but its owners, which is why Deloitte soon found itself becoming the focal point of numerous negligence allegations by a now disgraced family (Barlaup et al., 2009).

The Blame Game Begins

When major financial fraud occurs, many often wonder who is to blame, and just how far blame should extend. In the case of Adelphia and Deloitte, each party fully believed the other to be the one solely at fault. Adelphia was split between two feuding parties, the Rigas family, and the independent directors that had arranged for the Rigas family's dismissal. An article by Leonard et al. (2002) states the directors' belief that Deloitte should have "blown the whistle years ago," while Deloitte claimed, "the directors should have had better oversight." Both parties, however, could ascertain the high degree with which the Rigas family had corrupted the accounting processes and financial reporting of the company (Leonard et al., 2002). Allegations for who could be at fault heightened during the months leading up to the September indictment of Rigas family members after Deloitte was fired as Adelphia's auditor in late June, with PricewaterhouseCoopers taking over as the retained auditing firm ("Deloitte", 2002). The SEC opened an investigation into whether or not Deloitte aided Adelphia in its fraud for fiscal year 2000. At that time, the accounting firm, in regards to Adelphia's financial statements, had released an unqualified audit report, and the two lead auditors for the engagement team, Gregory Dearlove and William Caswell, signed off on the report, approving of an audit report so glaringly overlooking numerous elements of fraud (Meland, 2005).

Deloitte's Rebuttal

The SEC did indict Deloitte on the grounds of auditor negligence that led to the continued cover-up of Adelphia's massive fraud perpetration. Even before investigations began, Deloitte notified the SEC after the firm's dismissal that six Adelphia executives who may have been directly involved with the fraudulent activities were still employed by the company. From the moment of dismissal, Deloitte championed a defense based on the grounds that Adelphia willingly withheld vital financial information from the auditors, which led to an unrealistic picture of the company's financials. Deloitte's auditors had been asked in prior years to audit financial reports that would help the company garner monetary support from more creditors. In practice, requesting an audit such as this would not have been an issue. In this case, the firm points out the company's clear intention to have these reports processed and approved without supplying Deloitte with enough information to provide a clean audit opinion (Cooke, 2002). In Deloitte's defense that it held no knowledge of the fraud prior to 2002, the firm claimed that the first sign of any fraud came to light only as early as February 2002. In the firm's dismissal letter, they outline the recent uncovering of $700 million in company funds the Rigas family used to purchase Adelphia securities. Deloitte claims they were firm in insisting the Rigas family bring these transactions to the attention of the audit committee (Grover, 2002). Whether this matter would have raised any issue is hard to discern, seeing as how at the time, Tim Rigas still sat on the audit committee and exercised domineering control over what should have been an unbiased panel.

Despite Deloitte's best efforts to present a defense centered around non-negligent performance on its part, The SEC ruled otherwise. Over the course of 2005-2007, Deloitte would reach three settlements in class-action lawsuits. The firm's settlement with the SEC was the first in a wave of multi-million dollar financial agreements, with this payout totaling $50 million. The settlement was to be split equally between a court approved penalty and settlement of the administrative proceedings ("Deloitte reaches record settlement", 2005). Deloitte would eventually pay out a total $427.5 million to the SEC, Adelphia investors, and 38 of Adelphia's creditors ("Deloitte settles with Adelphia", 2007). A common theme existed between rulings in each of the settlements, with an order by the SEC stating the true issues at the core of Deloitte's negligence as "engaging in improper professional conduct…and failing to implement audit procedures designed to detect the Adelphia fraud." Director of the SEC's Northeast Regional office Michael Schonfeld explains further the glaring concerns of Deloitte's negligence, stating, "What is especially troubling here is that Deloitte recognized the risk of fraud posed by this client at the outset. When auditors turn a blind eye toward misconduct on a high-risk client and allow a fraud of this magnitude to go undetected, the consequences will be severe," ("SEC charges Deloitte", 2005). As Schonfeld believed, the consequences were quite severe, and in conjunction with millions in settlement payments, Deloitte agreed to adopt requirements that audit planning become more extensive, involving forensic accountants and taking extra precautions on such high-risk clients. These extra precautionary measures would be monitored for compliance by an independent consultant to ensure the changes were truly taking effect ("Deloitte reaches record settlement", 2005).

Applying Audit Risk Guidelines: Then and Now

In today's setting, auditors adhere to numerous guidelines and professional conduct requirements from the inception of the planning phase to the approval of the final audit report. Deloitte did make several grievous errors, but an argument could be made it was partly because professional audit standards were not up to par with where standards are today. For example, Statement on Auditing Standard (SAS) 95, which outlines the ten key Generally Accepted Auditing Standards (GAAS) that auditors must live and die by today, did not take effect until the audits of financial statements beginning December 2001, after Deloitte completed the fiscal year 2000 audit ("Generally accepted auditing standards", 2001). Included in SAS 95 are standards outlining the importance of exercising due professional care, achieving an understanding of the entity and its environment, and properly planning the work going into the audit.

SAS 45 on the other hand had long been in effect to lend guidance regarding related party transactions, which were highly evident in Adelphia's business scheme, even if some actions by the Rigas family were hidden from the auditors. Section .11 describes the extreme importance that an auditor has sufficient and appropriate evidence to support every possible related party transaction in order to determine if those transactions have been properly disclosed within the financial statements ("Related parties", 1976). Although Deloitte suggested Adelphia disclose information regarding the company's co-borrowing agreements that also involved several of its subsidiaries, the firm failed to carry out the standard set in SAS 45 when the company refused to disclose such transactions and Deloitte surrendered to their suggestion (Barlaup et al., 2009). An AICPA released publication interpreting SAS 45 (1979) also describes the process auditors should undergo when related party transactions are believed to be material, stating that other auditors for the related entities should be contacted with information being shared on both sides about the nature of the related parties and their interactions. In this case, Deloitte was the auditor for Adelphia, several of its largest subsidiaries, and other Rigas family entities (Cooke, 2002).

Audit standards stress the importance of proper planning and adequate training, especially when faced with high-risk clients. Adelphia, with its various subsidiaries and Rigas family entities, matched with vast amounts of acquisition debt, proved an extremely high-risk client. The very basis of audit risk is the idea that an auditor may unknowingly fail to uncover material misstatements on financial statements. Deloitte was auditing a company known for shrewd financing deals, hundreds of related party transactions taking place on a monthly basis, and cutthroat industry competitors, which culminates into the overall audit and fraud risk of the engagement being extremely high. Although an auditor should exercise professional skepticism when performing an audit, possible traces of fraud should not be dismissed. The warning signs Deloitte auditors would have seen on the 2001 fiscal year audit were too great to have been ignored ("Audit risk and materiality", 2006). Complex systems of guidelines are currently in place by numerous accounting oversight bodies such as the American Institute of Certified Public Accountants (AICPA) and Public Company Accounting Oversight Board (PCAOB) to help auditors identify warning signs of fraud. With these guidelines, an auditor today could prepare a more in-depth plan to assess audit risk and determine if fraud was present than Deloitte could have in 2001 on its fiscal year 2000 Adelphia audit.

In preparing for an audit with such high levels of risk, all engagement members should be aware of key financial statement areas that pose higher risk levels. In planning the Adelphia audit, lead auditors should have noted the potentially high-risk area of related party transactions, taking care to obtain more evidence of these transactions than what might be necessary for lower-risk transactions and account balances. The goal is to then provide reasonable assurance that such transactions are not materially misstated, but only after adequate evidence has been gathered and tested. Deloitte supposedly faced roadblocks when trying to obtain enough information to properly evaluate the related party transactions, specifically the co-borrowing agreements and monthly reconciliations of intercompany receivables and payables. Because Adelphia management personnel refused to provide the auditors with the evidence and information it requested for numerous material items, this should have led Deloitte to at least consider the possibility of issuing a qualified or disclaimer opinion on Adelphia's financial statements. Client-imposed scope limitations, especially when management refuses to make changes, provide requested information, or make proper disclosures, are glaring red flags that should make an auditor stop and question the integrity of the client's management and what management may be attempting to hide. The Deloitte auditors, regardless of what guidelines were in place at the time of the audit, should have taken into consideration the concerns raised by various material, related-party transactions and management's unwillingness to cooperate in investigating for misstatements. Ultimately, the audit should not have resulted in the issuance of a standard unqualified report.

Reducing Fraud Risk of High-Risk Clients

High-risk clients often incur much higher levels of fraud risk, and can create problems for auditors and their accounting firms if no actions are made to effectively address such risk. Whether the firm is looking to acquire a high-risk client for a first time audit, or the company has been a long-term client, fraud risk should still be assessed before beginning the engagement, throughout the auditing process, and even after the issuance of an audit report. By reducing fraud risk, auditors can oftentimes lower their own risk through implementation of procedures that help the client combat environments where fraud can thrive. For example, a fiscal year-end audit consists of providing reasonable assurance that the previous year's financial statements are free from material misstatements. Members of an engagement team should be acutely aware of management's integrity, especially in regards to their willingness to cooperate, and note any issues as a potential sign that fraud could be more prevalent if the ethics of such people are questionable even from the inception of the audit. The best possible course for reducing fraud risk on an individual basis can stem from each auditor exercising professional skepticism throughout the entire process. The goal is not to assume fraud is bound to exist when auditing a high-risk client, but the notion that the higher levels of risk could entail more difficult accounting procedures that lend itself to disguising risk more easily should be considered “Audit risk and materiality, 2006).

The AICPA and PCAOB have both put a greater focus on combatting audit and fraud risk in recent years, including stressing the importance of placing more emphasis on the planning process before beginning an actual audit. The prospective organizations collectively express a need to “exercise judgment about…significant risks, considering at least…the complexity of transactions, whether the risk relates to fraud, and if the risk involves significant transactions with related parties,” (D’Aquila, Capriotti, Boylan, and O’Keefe, 2010). The assessment of such risk should begin as early as the planning process with the implementation of various risk assessment programs. Common among large firms from as early as 2005, Risk Management Programs (RMPs) drastically changed the way firms could assess various aspects of high-risk clients to determine areas with the greatest levels of fraud risk. After Deloitte settled in the Adelphia case, it began to implement more tools to assess such risks, creating its Deloitte Radar (DDAR). The system used public data and quantitative formulas to determine a company’s inherent susceptibility to financial statement fraud. The firm utilizes this information to categorize its high-risk clients and include those deemed to have “much greater than normal risk” into the firm’s RMP. Through this system, additional partners and the engagement team can identify fraud-related factors the client should mitigate in order to reduce their overall levels of fraud risk. If a client can successfully reduce such risks, the company will “graduate” from the system and be able to better protect against fraud risk for future engagements. Deloitte recognizes that “its clients have a significant impact on our reputation as a public company auditing firm. As a result, risk management procedures are essential in…identifying and addressing engagement related risks,” (D’Aquila et al., 2010).

The issue in assessing fraud risk is that many firms look to reduce such risks when they begin planning or within the early stages of the engagement, thus failing to continue such procedures throughout the entire audit. This can leave a firm even more vulnerable and susceptible to fraud-related risks from procedures later on in the audit process that are not properly addressed. Deloitte experienced first-hand the ramifications of not maintaining risk-review procedures throughout an audit can cause, seeing this exact issue take place during the Adelphia audit. The SEC ruled that Deloitte only completed a cursory review of its audit plan and failed to follow-up on the fraud risks identified throughout the planning process. The ability to maintain strong review processes aids significantly in reducing auditor risk as a result of effectively lowering fraud risk (D'Aquila et al., 2010).

Oftentimes even though an auditor is highly knowledgeable of audit practices and has sufficient training, the work of a specialist in the client's industry itself may be garnered necessary. PCAOB AS 1210 states how an auditor "is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation." Because various industries involve subjective matters or complex transactions not common among every business, a specialist could provide valuable knowledge on industry standardized practices and how they should be treated. It is imperative, however, to ensure that the industry specialist is independent of the client and the audit firm to ensure that any advice and empirical findings are free from any bias that could potentially increase a client's fraud risk potential. The goal of utilizing a specialist is to mitigate any risk created through inexperience with an advanced industry's practices that without an educational background in the field, an auditor could not have known. By ensuring a client is following industry standards and practices, specialists offer an audit firm an extra layer of defense against fraud risk that could prove imperative in completing a difficult audit (The PCAOB, 2015).

The best possible way to decrease fraud risk when auditing a high-risk client includes a culmination of various practices. No single RMP or independent specialist can effectively mitigate fraud risk as a stand-alone implementation. A firm achieves better results when multiple safeguards are combined throughout the entire auditing process. Auditors can see great advantages when fraud risk of a high-risk client is effectively curbed. When these practices are implemented, auditors can "see a better return on time expended. Improving risk management heightens the quality of…audit engagement," (McDonnell, 2004). The strength of the accounting profession as a whole improves from a greater focus on increasing the quality of tactics to manage fraud risk of high-risk clients. This spurs an increase in firm-instilled goals to hold all involved within the audit process accountable for creating and upholding procedures necessary to improve the quality of the audit through effective decreases in fraud risk.

The Future of Audit Risk

Although auditing is often considered preventative, detective, and corrective when it comes to accounting errors and fraud alike, changes in auditing standards have a tendency to be preventative only after massive fraud comes to light. The current lack of guidelines that could potentially have prevented material misstatements due to fraud is often going unnoticed. In order to encourage the placement of early prevention adaptations to audit standards, organizations like the AICPA utilize exposure draft concepts that allow public discussion and commentary from those within the audit field themselves. By allowing auditors and other accounting professionals to work on developing new standards, the structure of guidelines can become a system of early prevention that matches the exponential growth of future clients, fueled by the knowledge of auditors themselves. The future of combatting audit risk and truly protecting all those invested within a client comes through the ability to recognize the need to constantly adapt and adjust guidelines, allowing those with the situational experience to improve the standards he or she should strive to uphold throughout the process of any engagement.

Conclusion

When presented with high-risk clients, it oftentimes is difficult to ascertain the proper way to approach an audit, which in the case of auditing Adelphia's financial statements, audit risk loomed high throughout the entire process. The need for adequate evidence in such high-risk situations resonates when the realization that fraud affects far more than just the company itself, extending beyond to test the very ethics and professional due care with which an auditor must conduct oneself. Further illustration of the effects that financial statement fraud can have is evidenced through a recent petition made by John Rigas. The former owner and CEO of Adelphia is currently serving a fifteen year sentence (Barlaup et al., 2009), but had petitioned for early release as he is terminally ill and dying of cancer. His petition was denied, with the district judge stating his bid for early release "failed to raise substantial claims" amidst still vigorous contests against his sentencing in the wake of his continuous belief of not having committed such grievous crimes as to warrant such punishment (Ciotta, 2015). The judge's ruling displays a no-nonsense approach to appeasing those involved in committing financial fraud, as she was able to see past Rigas' persuasive argument. As professionals, auditors must also be willing to go above management and owners of a company, especially those making excuses for a barrage of red flags surrounding the relationship of sixty-three entities surreptitiously acting as one.

References

Barlaup, K., Dronen, H., & Stuart, I. (2009). Restoring trust in auditing: ethical discernment and the Adelphia scandal. *Managerial Auditing Journal*, 24(2), 183-203.

Ciotta, R. (2015). Judge denies former cable company executive, Sabres owner John Rigas to leave federal prison.

Cooke, T. (2002). Deloitte says Adelphia officials attempted to withhold data. *The Wall Street Journal*.

D'Aquila, J., Capriotti, K., Boylan, R., & O'Keefe, R. (2010). Guidance on auditing high-risk clients. *The CPA Journal*, 32-37.

"Deloitte fired as auditor to Adelphia communications". (2002). *Accountancy Magazines,* p13.

"Deloitte reaches record settlement with SEC". (2005). *Public Accounting Report*, 1-5.

"Deloitte settles with Adelphia recovery trust for $167.5 million." (2007). *Public Accounting Report*, 1-7.

Grover, R. (2002). Adelphia vs. Deloitte in a game of blame. *Businessweek Online*.

Grover, R., & Lowry, T. (2002). A cable clan on thin ice. *BusinessWeek*, p48.

Johnson, L. R., & Rudolph, H. R. (2002). The lessons of Adelphia's cash fraud. *Journal of Corporate Accounting & Finance*, 19(1), 19-24.

Leonard, D., Harrington, A., Burke, D., Rigas, M., Rigas, T., & Cohen, O. (2002). The Adelphia story. *Fortune*, 146(3), 136-148.

McDonnell, P. (2004). The PCAOB and the future of oversight. *Journal of Accountancy.* 98-101.

Meland, M. (2005). SEC alleges Deloitte auditors aided in Adelphia fraud. *Law 360*.

"Personal piggy bank". (2002). *Maclean's*, 115(31), 12.

Solomon, D., Frank, R., & Markon, J. (2002). Adelphia related-party deals probed. *The Wall Street Journal.*

The AICPA. (1972). Adherence to generally accepted accounting principles.

The AICPA. (2006). Audit risk and materiality in conducting an audit.

The AICPA. (2001). Generally accepted auditing standards.

The AICPA. (1976). Related parties.

The AICPA. (1979). Related parties: auditing interpretations of section 334.

The PCAOB. (2015). AS 1210: Using the work of a specialist.

The SEC. (2002). SEC charges Deloitte & Touche for Adelphia audit.

The SEC. (2002). Litigation release no. 17627.