Unique Auditing and Reporting Aspects of a Community Antenna Television System

By ALAN S. BERK, CPA

This is one of a series of occasional industry articles designed to familiarize practitioners with the unique auditing and reporting aspects of different industries.

This article briefly describes certain auditing and reporting problems which are unique to a community antenna television (CATV) company. Since the industry is a relatively new one, and because of the nature of its operations, these problems are very interesting and challenging and their disposition and solution require a great degree of imagination.

SOUNDNESS OF THE INTERNAL CONTROL

Since many CATV offices are staffed by only one or two clerks, one of the major auditing goals is to determine that the company's internal controls are effective enough to assure that it has received all of the revenues to which it is entitled; that is, that all of the customers "hooked into the system" have, in fact, been paying monthly and that these monthly payments have found their way into the company's bank account.

The Diversion of Customers. Avoidance is easy, as this illustration reveals. A new customer completes an order blank requesting that service be installed in his house. A technician is sent around to string a wire from a nearby telephone pole into the house and then into the TV set. The customer pays monthly for this service.

What is to prevent a dishonest serviceman or other qualified person, who acquires lengths of wire, other small pieces of equipment and a ladder, from proceeding around the neighborhood, selling the services and "hooking in" his "own customers," explaining to them that he is the CATV serviceman and that in the future he will make the monthly cash collections.

One can't string half a town in this manner and get away with it, but it is clear that the dishonest serviceman or other person can clearly supplement his income in a sizable way by use of this method. There is usually little to prevent this from happening but its elusiveness should not preclude efforts at detection.

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Problem of "Disconnects." A related problem is the internal control over "disconnects," customers whose service has purportedly been discontinued. This can be exploited by the clerk who deals with the collection of cash (such as the counter girl in the office) by reporting a customer as a "disconnect" when, in fact the customer has not been disconnected. Such a customer will unwittingly keep paying the monthly charges and the dishonest person will significantly increase take-home pay.

A substantial portion of CATV revenues is paid monthly by mailed checks but some customers pay in cash, in person, at the local office. Whenever there are many customers making monthly payments of small amounts in cash, stringent internal controls should be established to prevent exploitation.

TESTS OF INTERNAL CONTROL

To test the internal control the independent auditor may use the following procedures (although appropriate company employees may also perform any or all of them throughout the year).

Physical Inspection. Get into a car with the system manager and ride around town, making notations of the addresses of certain of the houses which are connected to the system. This, the auditor can do by looking for the wire lead from the telephone pole to the house. (Sometimes this lead wire is removed or left dangling from the telephone pole if service has been disconnected). A comparison of the addresses noted with the subscriber records at the system office will provide a reasonably check of whether houses connected to the system are recorded as such in the company's records. In multifamily dwellings this visual check may not be practicable.

Confirm Receivables. Confirm the correctness of the company's accounts receivable records directly with subscribers.

In addition, the auditor should recommend that, during the year, the company write a letter ("sorry we lost you" type) to each subscriber reported as a "disconnect." This could bring to light operating problems in the system; serve as a "last ditch" collection effort in those cases where the disconnect resulted from nonpayment; and, from an internal control viewpoint, detect fraudulent "disconnects."

ACCOUNTING FOR INVESTMENTS IN INTANGIBLES

A company which is constantly seeking and acquiring additional franchise territories has the problem of determining the proper accounting for intangibles created by preoperating expenses, development and investigation expenses and franchise expenses. Substantial amounts are usually expended in an investigation and to obtain franchises. Obviously, some efforts are unsuccessful, in which case the expenses incurred are a total loss. The determination of when the loss is certain requires a subjective evaluation.

During the period of construction, expenses such as interest, travel, etc., are incurred. Should these expenses be capitalized or written off as incurred? This is a judgmental decision, depending on the circumstances in the individual case.

At any point in time the auditor must be able to evaluate the potential success of each location for which expenditures were incurred. If the location has been abandoned, then the expenses obviously have no future benefit and should be charged off. If construction of a system is in process or is contemplated, then the preoperating costs and costs incurred to obtain the franchise should be deferred and amortized over the period to be benefited. In the case of a system with a franchise for a limited period of time, say 10 or 20 years, that period should normally be the one benefited. In the case of a system which is covered by a perpetual franchise (i.e., no limited time period) or where the company feels that the economic useful franchise life is shorter than its legal life, an arbitrary period, say 15 years, is often used.

Some people believe that no CATV preoperating period-type cost (principally selling and general and administrative expenses) should be deferred but, instead, should be charged off in the period incurred. This conservative practice seems to make sense once the system is operating but, in the preoperating stage it can be reasonably assumed that expenditures are incurred for the production of future revenues and should therefore be deferred and appropriately amortized.

Capitalization vs. Write-Off. Where costs are deferred, the amortization policy should be periodically reviewed for changed conditions. The auditor must be satisfied that costs deferred can be recovered from future profitable operations or by a profitable sale of the system. In the case of a new system —or an established system that doesn't seem to be doing too well—this subjective judgment becomes very difficult. The auditor should be reasonably satisfied that present plus potential subscribers will produce revenues in sufficient amount to cover deferred expenditures. At best, this is a very challenging evaluation.

The Utilization of Budgets and other Projections. In this determination, the importance of reliable budgets and subscriber growth projections cannot be overemphasized. Projections and budgets prepared at the outset should be constantly and realistically updated. Without such projections it is impossible to make an intelligent projection of operations.

It has been said that a system should have almost all of its potential subscribers "hooked in" within approximately two years. A system which, for instance, has only 20% of its potential subscribers "on line" after three years is probably losing money and is probably in serious trouble. If it is virtually impossible for the independent auditor to satisfy himself as to the future realization of the assets, depending on the materiality of the amounts involved, he must strongly consider qualifying or perhaps even disclaiming an opinion on the financial statements taken as a whole.

HAZARDS OF GOVERNMENTAL ACTIONS

The possible future effect of government regulation is another material uncertainty that presently is inherent in the operation of a CATV system. The reporting accountant must look hard and long at the existing, pending or proposed federal legislation and at current litigation to be satisfied that no materially adverse effect could reasonably be expected to occur in the financial position or operations of the system. If the effect might be material, because of its location, the nature of its operations, or other circumstances peculiar to it, then the auditor must consider very carefully whether or not he should give a "subject to" opinion or perhaps even disclaim an opinion on the financial statements.

TECHNICAL OBSOLESCENCE

Another major problem (raised only by outsiders) facing the CATV industry is that of technical obsolescence of equipment and, more importantly, of the industry. Of course, it is impossible to predict the effect on CATV of direct broadcasts to the home from satellites hovering over the earth. Although predictions of this possibility sound fantastic now, one must remember that inventions of the last couple of decades seemed just as dreamy then.

As independent auditors, we cannot discount the possibility of such a thing happening even though there are many political and economic reasons why the progress of technical change may be retarded. In any event, no one can say, with absolute certainty, that the "satellite in the sky" concept is completely erroneous.

SUMMARY

This article briefly described some of the auditing and reporting considerations which are peculiar to the examination of the financial statements of a cable (CATV) system. While there are innumerable other considerations in the audit, they are substantially similar to those in any other audit.

Lastly, it is important to remember that the certifying accountant must be ever mindful of the potential impact of current developments in the broadcasting industry on the survival of the CATV industry, whether from governmental actions of an adverse nature, technical obsolescence, or competition from other types of transmission systems.

The Accounting Profession Is At The Crossroads

The accounting profession is at the crossroads. We seem to be heading away from our task of providing relevant financial information to management and the resulting gap is being filled by non-accountants. At the same time, we seem to be expanding into an area that does not have accounting as its basic discipline. Thus, in a few years, the accounting profession may be excluded from many of the important areas of management decision-making, while being deeply involved in performing functions only indirectly related to accounting. Specifically, this means:

1. We are getting more and more deeply involved in data processing which is, at best, only indirectly related to the accounting discipline.
2. We are doing little or nothing to develop the new costing techniques required by modern business.
3. We are doing little or nothing to develop and apply the new financial control techniques required by modern business.

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