Helecom Communications:
Considering Fraud Risk on an Engagement Before and After Analyzing A Key Business Process

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ABSTRACT

Helecom Communications is a fictitious public company in the cable industry, founded by its current Chairman and CEO, Jefferson Means. For this case, students assume the role of an associate auditor in an international accounting firm that has just acquired this client. Students are provided with background information on the company and its environment in Part 1 of the case and provided with information related to a critical business process, subscriber management, in Part 2 of the case.

This case involves considering fraud risk of an organization in a competitive, regulated, and volatile industry. For this case, the established criterion is AICPA Statement of Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit (SAS No.99). While many of the facts in the case are adapted from fraud risks and actions that occurred at actual organizations, the company is fictitious to enable the case to place students in the role of the auditor evaluating the organization for fraud risks both before and after analyzing a key business process. By performing the requirements in this case, students are exposed the key aspects of SAS No.99, which should be maintained and possibly expanded pursuant to consideration by the Public Company Accounting Oversight Board (PCAOB), within the context of audit approaches being used to some extent by all international accounting firms (e.g., Lemon et al. 2000).
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INTRODUCTION

You work as an associate for an international public accounting firm that has just been engaged to conduct the financial statement audit for Helecom Communications. The Company is led by Chairman and CEO, Jefferson Means, who is the founder. One of his sons, Jefferson Means, Jr., is the CFO, and served as chair of the audit committee prior to passage of the Sarbanes-Oxley Act of 2002, was instrumental in your firm being chosen as the auditor (the engagement partner from your firm knew Jefferson Jr. from their days at Georgia A&M). This engagement was available because the firm that had been auditing Helecom was dissolved during the prior year, meaning that a new auditor had to be selected and that no communications with the prior auditor were possible. To compound the challenges associated with performing a first-year audit, Statement of Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit (AICPA 2002), has recently been issued, and this is your first client on which to implement the new standard. As part of your responsibilities on the engagement, you learn that you will be performing the business process analysis of subscriber management, although you will be helped by the manager on the engagement because of the importance of the process as it relates to revenue recognition for the client.
PART I: CONSIDERING FRAUD RISK PRIOR TO ANALYZING

A KEY BUSINESS PROCESS

Background

Telecommunications Industry

A brief history. The telecommunications industry experienced unprecedented, rapid growth in the mid-1990s, introducing an array of services and competitors to an industry once known only for home phone service and the industry giant AT&T. The changes resulted from antitrust sentiment waged against the Baby Bell local phone companies (formerly pieces of the divested AT&T) and the passage of the Telecommunications Act of 1996. The Act dissolved the monopolies held by the Baby Bells on local phone services and opened the market to a variety of competitors, including cable companies, network broadcasters, and wireless service operators. The Baby Bells were required to make their infrastructures (i.e. cables) available to competitors. In return for their sacrifice, the Bells were allowed to enter into new markets such as cable and TV services, equipment, and long distance. With a more level playing field, telecommunications has evolved into a highly competitive industry.

Products. Firms competing in the telecom industry can be sorted into various market niches, though several large industry players offer products in all niches. Products offered by the telecommunications industry can be categorized as phone-related, television-related, or Internet-related. In each of these product divisions, there are firms that produce the telecommunications equipment (e.g. coaxial cable and cable boxes) for wholesale to service providers and firms that provide the actual services and equipment to consumers.
Phone-related products historically included local and long distance phone services using copper lines as a communications medium. In the mid to late 1980s, long distance carriers such as MCI and Bell Atlantic began constructing fiber optic cable networks, made from glass rather than copper, that were purported to be a significant improvement over copper lines due to much greater bandwidth (the capacity for data transmission). One of the most recognizable long-distance service ad campaigns was launched by MCI, who claimed that on their fiber-optic cable, one could “hear a pin drop.” Fiber optics hasn’t replaced copper as of yet, likely due to the vast existing infrastructure of copper cable that would require a massive investment to replace. Some market participants think that copper will eventually be displaced by wireless capabilities rather than by fiber optics. Indeed, wireless services via analog and digital media already represent a large market niche in telecommunications and Plunkett Research predicts continued growth in wireless communications (Plunkett Research 2002).¹

Firms in the television products market have capitalized on “broadband” transmission methods. Using broadband, multiple transmissions share a common communications path. Thus, cable television providers are able to offer high-speed Internet access in addition to digital video and audio for the TV across the same cable. Broadband also includes satellite delivery or DBS (direct broadcast satellite), which is competitive with cable firms’ digital TV but not so much with Internet access. Phone companies also have gained from new transmission methods by introducing high-speed Internet access via digital subscriber lines (or DSL), but they also trail broadband cable

¹ The regulatory changes in late 2003 that enable consumers to switch their home phone numbers to wireless phones and to maintain phone numbers when switching carriers has been widely reported as an indicator that wireless technology might replace wired technology.
firms for market share. A growing industry trend is to “bundle” cable television, telephone, Internet, and wireless services for consumers.

**Recent industry threats.** *Forbes* reports that $1.3 trillion has been contributed to the industry by investors since the passage of the 1996 Act, much of it during the technology boom of the late 1990s. A majority of the capital has been used by telecom firms to purchase wireless bandwidth or construct cable networks. *Hoover’s Online* reports that much of the approximately 90 million miles of cable that has been constructed is still unused, and has caused the wholesale price of network capacity to plummet (Hamerly 2002). The driver of this excessive construction was a statistic provided in 1997 by Michael O’Dell, then chief scientist of UUNet, that estimated Internet traffic would double every 100 days, or about 1000% per year. The hypothesized statistic spread quickly throughout the industry. Unfortunately, actual demand is now believed to have only grown by 100% per year and has grown at declining rates since that time (Dreazen 2002).

A compounding problem is that most telecommunications firms suffered dramatically when the technology bubble burst in 2000—largely due to the aforementioned overstated demand. Telecommunications historically has been an industry with a high level of merger and acquisition activity. Larger firms frequently acquire smaller firms for their capacity or existing customer revenue streams. In the late 1990s, however, the acquiring firms’ share prices began to tumble as the purchased capacity could not be turned into revenue. Soaring predictions from industry analysts and unrealistic shareholder expectations led several firms to falsify accounting figures to satisfy constituencies. Various frauds and restatements within the telecom industry have
hit the news in recent times. Notable examples include Qwest, AOL, and Worldcom. In the latter, a fraudulent accounting scheme perpetrated over years 1999 to 2001 directly reduced expenses and inflated reported net income by approximately $7 billion, and resulted in the firm re-naming itself MCI in 2003. The scheme was relatively basic. Some of the firm’s largest costs were fraudulently classified as capital expenditures (Markon 2002). The industry has witnessed the falter of worthy competitors, such as 360Networks and McLeod, Inc. Taken in sum, investor confidence in the telecom industry has been shaken.

*The Story of Helecom Communications*

**Humble beginning.** Jefferson Means, CEO and founder of Helecom, was born in 1938 in Helena, Alabama, and was the youngest of five children. William and Opal Means instilled in their children a strong sense of family values, as well as the belief that hard work, a little business sense, and attention to customer relationships could build or maintain a successful business. William was sure to involve all of the children, to some degree, in the day-to-day business of the family-owned Helena Feed & Seed.

After his father died and his older siblings assumed the family business, Jefferson decided to become the first in his family to go to college. He was easily accepted to Georgia Agricultural & Mechanical Institute where he earned good grades in his engineering curriculum. While at Georgia A&M, Jefferson discovered his natural ability to build and wire just about anything.

After graduating in 1960, Jefferson married Lilly, his high school sweetheart, and moved to a small city about seventy miles north of Birmingham, called Gadsden. The
town’s livelihood was dependent on two factories—Republic Steel and The Goodyear Tire and Rubber Company—and Jefferson had taken an engineering job with the latter. Jefferson and Lilly enjoyed living in Gadsden. One of their favorite things about the town was that the Coosa River ran right through the heart of it. Jefferson and Lilly decided to investigate buying a piece of waterfront property in the nearby town of Hokes Bluff that had been placed on the market by a financially distressed family. Unfortunately, the steep grade of the land made it a poor choice for building. However, there was something on the land that was much more interesting to Jefferson than the lot’s suitability for a house—an 18-foot tall antenna. The current owner liked to tinker with radio and explained that he’d lost interest in the antenna before ever “getting the kinks worked out.” To Lilly’s dismay (after seeing the lot), Jefferson offered $700 on the spot and the owner accepted. The wheels in Jefferson’s mind were turning.

Jefferson put his wiring skills to use and convinced nearby residents to let him string some wires to their television sets. They agreed out of sheer curiosity. Soon Jefferson was urging the rest of Hokes Bluff to trade their rabbit ears for wires to his antenna, making Jefferson an early pioneer of the cable television industry.

Over the next several years, Jefferson acquired other plots of land in neighboring towns—Glencoe, Cedar Bluff, Centre, Piedmont—and built more antennas and strung more wires. One week after quitting his job with Goodyear, he went into the First National Bank of Gadsden to borrow $45,000 to purchase the failing cable franchise in Gadsden. When the bank said no, Jefferson convinced several local businessmen to contribute $25,000. Prodded by one of those businessmen, the bank president agreed to lend the remaining $20,000. Jefferson told Lilly that they would “either make a mint or
“go broke.” Lilly had no idea that Jefferson would make that claim many more times in the future.

By the late 1960s, Jefferson’s cable business was doing well and he purchased a 60-acre river-front property in Hokes Bluff and built a beautiful 8,200-square-foot home for Lilly and his two sons, Jefferson, Jr. (Junior), and George. Jefferson and Lilly were easily the most “successful” residents in the history of Hokes Bluff, and the more successful they became, the less popular they became. As in most small towns, all 2,900 townspeople in Hokes Bluff were at about the same socioeconomic level, at least until Jefferson’s success. Jefferson and Lilly wanted to feel at home in Hokes Bluff and tried everything to earn acceptance in the town. Jefferson ran for a position on the school board—and lost. He hosted barbeques at his home—few came, and those mostly out of curiosity over the estate. He went as far as attending the church preferred by the mayor, which differed from his religious denomination. Finally, in 1975, his goal to be accepted in the community was realized when he was invited to sit on the board of the local bank. Not only was this a great personal triumph but he foresaw needing a loan from time to time.

**Growing Pains.** Jefferson continued to operate his cable business out of his garage with the help of a secretary and two linemen. As his ambition grew, he took significant risks and leveraged the company in order to acquire and develop more rural cable systems in Alabama and Georgia. Often, he was only one step ahead of creditors. He constantly told Lilly and the boys, “We’ll either make a mint or go broke.”

Jefferson pushed Junior and George to be overachievers. Both lettered in a sport. Lilly drove them into Gadsden once a week for piano lessons. Junior, the older of the
two, graduated as Valedictorian among his 52 classmates, and George graduated as Salutatorian two years later. After graduating from Georgia A&M, both sons returned to Hokes Bluff to work for their father. Jefferson built a large cinderblock warehouse to house his headquarters and hired a secretary for each son. People wondered why so few employees needed such a large space, but they were unaware of the deal that Jefferson had made, growing his subscriber base from 28,000 to 90,000 overnight. Other large acquisitions followed. By the mid 1980s, the company had 160,000 subscribers and 250 employees. Based on his financial management strategy, there was not a bank within a 200-mile radius with which Jefferson did not have debt. Frankly, he and the boys had borrowed about as much as they could. Over a plate of Lilly’s meatloaf one fall evening in 1987, they decided to go public. Upon Junior’s suggestion, Means’ Cable became Helecom Communications.

**Current status.** By the late 1990s, Helecom was among the 10 largest cable companies in the country, with over 25,000,000 subscribers. The public offering had given Jefferson the cash needed to take the company to the next level. Although the greatest cluster of subscribers was in the Southeast, Jefferson had developed other clusters in the Midwest. George Means developed the strategy of clustering subscribers in geographic areas, which was lauded by analysts. Clustering helped to keep operating costs low and gave Helecom a much greater cash margin than its competitors.

George invested in new technologies, such as wireless and digital services, and pushed to become industry leader. Like his father, he was always looking for a profitable deal in these new service lines. He had identified several targets in the wireless market in 1995 that had been beneficial acquisitions for Helecom. However, there were a couple of
targets for which his “business case” had been less appealing to Jefferson and Junior, one in home security and one in cellular. George could not persuade Jefferson that entry into the home security line would be profitable, so that particular deal never came to pass. Jefferson also was cautious of the wireless target, as it had some formidable obstacles to overcome (hence its discount) and was located in an area far from Helecom’s other clusters. Neo Wireless, a new cellular company in rural Southern California, was in the midst of a lawsuit with the FCC over a disputed tie bid for a wireless spectrum (the Federal Communications Commission auctions wireless “airspace” to wireless companies). George believed that although Neo was much smaller than the other tie-bidder, Neo would eventually come out of the suit with the spectrum and would be a profitable company with high growth potential. George wanted to create a new cluster in the Southwest. Jefferson went against his better judgment and agreed to purchase Neo to appease George. He was adamant, however, that Neo would not become part of Helecom. Instead, Neo would be a stand-alone entity, and a personal project for George.

Based on age, experience, and interests, the top of Helecom’s governance hierarchy was structured with Jefferson as Chief Executive Officer (CEO), George as Chief Operating Officer (COO), and Jefferson, Jr., as Chief Financial Officer (CFO) and Chair of the Audit Committee. Jefferson and Junior designed the IPO such that Class A shares with one vote each were issued. The Means retained all Class B shares, with five votes per share, giving the Means final word on who would hold board seats. Most other members of the Board of Directors were good friends of Jefferson’s, from days at A&M, Goodyear, and the local bank. Lilly’s cousin from Helena also held a seat.

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2 Based on the requirements in The Sarbanes-Oxley Act of 2002, Jefferson, Jr. resigned from the Audit Committee, and the President of the Hokes Bluff Bank, Johnny Kinsey, took Jefferson’s place as Chair.
Coincidentally, these were about the only shareholders willing to travel to Small-town, USA, for board meetings or annual shareholder meetings (which were held at the Gadsden Country Club with a round of golf following). Board and shareholder meetings alike were mostly informational where Jefferson shared with those present about the company’s recent victories and the deals put together by the boys and him.

Outside of the boardroom, the Means’ continued to run the business just as they always had—at the dinner table over Lilly’s home cooking—with little thought to investors, analysts, or other stakeholders. Jefferson continued to make the deals that had made Helecom successful. He sought smaller competitors within geographic clusters for acquisition, most of which had unused capacity that could be developed by George to further expand Helecom’s subscriber base. In November, 2000, Jefferson had six to eight deals on the table, most with commitments to purchase stock at some agreed upon price. Jefferson’s deal-making required him to keep Helecom highly leveraged. But, in his mind, he had mastered that art and he knew that Helecom’s goal to become industry giant depended on it! At times, Helecom’s debt was 10 times its market capitalization, and 10 times that of any competitor. However, annual revenues approached $2.5 billion, and the stock price continued to climb in the late 1990s. Jefferson, George, and Junior increased their ownership by purchasing a large volume of stock. Jefferson had faith that the company would continue to prosper, enabling him to divest some of his shares upon retirement.

Jefferson also had established various privately-owned businesses over the years. He insisted upon keeping his salary from Helecom at a conservative amount (e.g., Jefferson’s average salary over the years 1996 to 2002 was $800,000 per year) and these
businesses allowed him to subsidize his personal income.\textsuperscript{3} One of the businesses, MediaMarket LLC, was an advertising company that focused primarily on telemarketing services. It had several small Gadsden-area clients and Helecom. MediaMarket handled the majority of Helecom’s marketing to potential subscribers for services in areas where it had services available. Jefferson also created Service Link LLC, a customer service outsourcing agency. Its primary revenue stream was from Helecom, but other clients included the local Hokes Bluff bank and two other banks from surrounding towns. Both MediaMarket and Service Link were located in Helecom’s office building. Lilly and George’s wife, Emily, also operated a florist and home interiors business. The two hospitals and the funeral home in Gadsden provided sources of demand for the florist, and the Gadsden country club provided demand for the interiors business. Often, Jefferson would redecorate Helecom’s offices to provide business for Lilly and Emily. Jefferson could see the value in his small companies. MediaMarket and Service Link lowered Helecom’s operating costs and both of the companies received professional management fees from Helecom.

By 2001, the sentiment toward the Means family was warm. After all, the Means treated folks in Hokes Bluff like extended family. They built youth recreation facilities, sponsored an annual fair, and built a library and seniors’ center. Jefferson was rumored to have never turned away anyone who came to him in financial difficulty. Further, townsfolk were often invited as personal guests of the Means to Atlanta Eagles pro football games and shows at the historic Antebellum Theatre. (They had acquired both in

\textsuperscript{3} Jefferson insisted that Junior and George also draw modest salaries, the former earning an average of $550,000 and the latter, an average of $400,000 per year.
the 1990s.) Jefferson was finally admired by all and wealthy beyond belief. He had realized his dreams—those for his company and for himself.

**Required**

Prepare for a brainstorming session on Helecom Communications to take place during class on February 24. Consider the elements of the fraud triangle and fraud risk factors (control environment, industry conditions, operating characteristics, susceptibility of assets to theft, pressure to meet earnings targets, complexity of transactions, etc.) as part of your preparation.