AUDITING ISSUES ENCOUNTERED WHILE AUDITING A DEVELOPMENT STAGE CORPORATION

Jeff Hemker, Southern Illinois University Edwardsville
Brad Reed, Southern Illinois University Edwardsville
Cathy Tornaritis, Southern Illinois University Edwardsville

CASE DESCRIPTION

This case analyzes the auditing issues that can arise when auditing a start-up company. While the issues discussed in this case could occur at a mature company, dealing with these issues in a start-up company provides an added layer of complexity for the auditor. The audit issues encountered in this case include related party transactions, materiality decisions, subsequent events, and changes in the auditee's line of business. The case works best if it is used after these auditing topics have been covered in class. Since these topics may be covered late in the semester, the case is best used toward the end of an audit course. Appropriate for an introductory auditing course, the case has a difficulty level of 3/5. In its entirety, the case can be covered in one 75-minute class period. It works well as a discussion activity led by the instructor or one in which students work in groups and then discuss their answers as a class. If the case is used towards the end of a traditional auditing course, no outside preparation is required of the students, as they will already be familiar with the topics. If the case is being used prior to coverage of related party transactions and subsequent events, one hour of outside preparation by the students is required.

CASE SYNOPSIS

Obscene Jeans Corporation started in 2009 with the business plan to design a woman's line of jeans, labeled Obscene Brand Jeans. The company raised money and hired a well-known fashion designer. The company's first public financial statements indicated that it would take 9 months to design and manufacture the first jeans for re-sell. Five years later, the company had never produced any jeans to be sold, had consumed over $2 million dollars, changed their business plan to making games for social media platforms, and gone through three CEOs and three auditors and was out of business. Subsequently, news reports revealed that Obscene Jeans Corporation was part of a group of companies using a pump-and-dump strategy to take advantage of unwary investors. Over its relatively short life, Obscene Jeans Corporation experienced many issues that are difficult for auditors to address. This case examines a few of the auditing issues presented by the case of Obscene Jeans Corporation. The case is interesting because, although there is official guidance provided by the auditing standards for the issues presented, the case helps illustrate the amount of professional judgment required by the auditor, even with the guidance provided by the official pronouncements.

THE CASE

Jane is a senior auditor at the CPA firm of DEF CPAs. In December 2014, Jane's CPA firm accepted a new client. The client subsequently declared bankruptcy in 2015 prior to DEF CPAs issuing an opinion on the financial statements. Investors are suing the prior auditors. Jane's firm has decided to use the issues presented at the company as a learning experience to help the firm avoid future litigation. Jane has been asked to review the company's financial statements from 2009-2014 to identify and research some of the accounting and auditing issues within the company. Jane's research focused on the publicly available financial statements from the company.

Obscene Jeans Corporation (OBJ, later changed to Obscene Brand Jeans Enterprises) was incorporated in the State of Florida in 2009 as a for-profit company. OBJ was a development stage company[5] and planned to design a woman's line of jeans branded as Obscene Brand Jeans. The product line was intended to be sold in high-end boutiques in the United States and Italy.

A press release (See Exhibit 1) provides some background on OBJ's business plans. At this time, OBJ had not produced or sold any apparel. OBJ's designer, Rachel Stark-Cappelli, had 15 years of experience in jean design in Florence, Italy.

Exhibit 1
OBJ Press Release

Obscene Jeans (OTCQB:OBJE) visionary Robert Federowicz is a man of many subtle charms. He's a successful business executive, maintaining close contacts on both sides of the Atlantic. He's multi-lingual, which comes in handy making new friends in the party capitals of Europe.

And perhaps most impressively, the striking CEO knows how to rock a pair of jeans.
"It all starts with a good, dark wash," Federowicz says, laughing. "Styles come and go, so it's most important to find a flattering fit. You've got to pay attention to the seam placement, the yoke."

Fabulous, to be sure. But got any advice for the ladies with no idea what a "yoke" is, Robert?
"Basically, you want to find the pair that makes your butt look irresistible," he says, flashing a gleaming grin. "Jeans should be sexy. Of course, finding the perfect jeans is sometimes a bit easier for men."

Creating the Perfect Pair for the ladies of the world will be the tall task tackled by Federowicz's new company. Obscene Jeans is an innovative new fashion firm determined to transform the world of denim. Backed by Federowicz, designer Rachel Stark-Cappelli brings 15 years' experience outfitting catwalks from Florence to Miami to the table, creating a one-two punch of innovation. The pair is producing new lines coupling high-fashion denims and eye-popping metallic mesh to accentuate the female form as no other jeans dare.
"Rachel's designs are not for shy women," Federowicz said. "Obscene Jeans are made to stand out. We want them to look amazing, obviously, but we're also incorporating sensual textures into the fabric.

[5] A development stage entity was defined as an entity that had not begun its principal operations. Prior to 2014, development stage entities had reduced disclosure requirements compared to a normal corporation. In 2014, the accounting rules were changed to eliminate the distinction between a development stage entity and a traditional company.

"These are designer jeans re-imagined as a sumptuous feast for the senses," he said, his boyish grin long vanished. Federowicz takes blue jeans very seriously. "A lot of science goes into creating the perfect pair of jeans," he said. "Side seams that are pulled forward have a slimming effect. Angled pockets add a little perk to your butt. And medieval Florentine steel mesh woven into the fabric makes jeans look and feel exquisite."
Federowicz envisions the Perfect Pair as the cornerstone of a fashion and lifestyle empire that will eventually include an expansive women's line, casual apparel, fragrances, even rejuvenating cosmetics.

For now, though, he and his company are focused on what Federowicz knows best.
"My vision is for women to feel sexier in their Obscene Jeans than in any other garment in their closets," he says, smiling again. "We're designing amazing jeans that demand to be shown off."

Obscene Jeans produces eye-popping denim fashions for the world's sexiest women. The company competes in the fashion sector alongside True Religion Apparel, Inc. (NasdaqGS: TRLG), Maidenform Brands, Inc. (NYSE: MFB), Liz Claiborne, Inc. (NYSE: LIZ) and Polo Ralph Lauren Corp. (NYSE: RL).

Source: (March 16, 2011 Wednesday). Obscene Jeans President Federowicz Envisions Denim-Wrapped Perfection; New Company Leader Aims to Help Women Taste Jet-Set Fasion, Lifestyle. Business Wire. Retrieved from https://advance-lexis.com.libproxy.siue.edu/api/document?collection=news&id=urn:contentItem:52D9-CDW1-JBG1-81GF-00000-00&context=1516831.

OBJ planned to leverage Stark-Cappelli's experience with operation and management in the apparel industry (Ms. Stark-Cappelli was later named CEO of OBJ). OBJ's financial filings stated that it planned to raise $500,000 to implement the business plan. The following paragraphs will discuss some of the important events in the unusual life of OBJ. The narrative of these events is provided in chronological order. The events discussed either have direct audit implications or provide the context for other auditing issues.

Fiscal Year August 31, 2010

Since its founding in 2009, the company needed to raise capital, especially since it had made no sales (see Table 1). In September 2009, the company sold 9,000,000 shares of common stock to its CEO, Ms. Stark-Cappelli, for $0.001 per share ($9,000). The company states in its notes to the financial statements that the terms and amounts related to the stock sold to its CEO "…are not necessarily indicative of the terms and amounts that would have been incurred had comparable transactions been entered into with independent parties"[6] (OBJ 2010). During August 2010, the company issued 3,000,000 shares of common stock to qualified investors for $0.0175 per share, for a total of $52,500 (When the stock started trading the price ranged $0.60/share to $3.00/share in the year ended August 3, 2011. These two equity transactions

[6] It may be helpful at this point to review the professional literature regarding related parties. Guidance can be found in the Accounting Codification ASC 850 as well as in the Auditing Standards in AS 2410, available at: https://pcaobus.org/Standards/Auditing/Pages/AS2410.aspx

raised a total of $61,500 (see Table 2). OBJ noted in the 2010 financial statements that OBJ would raise more capital. OBJ's business plan was broken into two stages; the first stage included the design of the jeans and identification of manufacturers and was estimated to cost $150,000. Phase II included the manufacture and marketing of the jeans and was expected to cost $350,000 (OBJ 2010).

Table 1
Obscene Jeans Corporation (A Development Stage Corporation)
Statements of Operations

	2014	2013	2012	2011	2010
Sales	$753	-	-	-	-
Expenses:					
Game Design	165,516	-	-	-	-
Gen. and Admin.	1,187,941	295,534	608,038	1,267,017	20,572
Stock based Compensation	309,601	-	-	-	-
Loss on acquisition of 20% of Novalon	25,000	-	-	-	-
Impairment on joint venture	22,646	157,500	-	-	-
Loss from Op.'s	(1,709,951)	(453,034)	(608,038)	(1,267,017)	(20,572)
Other (net):					
Interest Income	31	-	-	-	-
Other Income	94	-	-	-	-
Interest Expense	(665,449)	407,267	(278,959)	-	-
Net Loss	$(2,375,275)	$(860,301)	$(886,997)	$(1,267,017)	$(20,572)
Sources: (OBJ 2011), (OBJ 2012), (OBJ 2013), (OBJ 2014), (OBJ 2015)					

Fiscal Year August 31, 2011

In November 2011, Ms. Stark Cappelli resigned all positions with the company (after the date of the auditor's report). The company stated that it was evaluating whether to stay in the jeans business. A new CEO (Paul Watson) was hired, was being paid $5,000 per month, and was the only employee. During 2011, the company received $590,353 in advances. Advances are not collateralized and are due on demand. On Sept. 26, 2011 (after the date of the financial statements but prior to the issuance of the audit report), OBJ made an agreement with the lender to refinance a portion of these advances ($78,885) into a convertible promissory note.[7] The note had a 10% interest rate and was convertible into stock at a valuation of $0.01 per share. This was the first of multiple conversions of advances to convertible notes (OBJ 2011). OBJ's financial statements indicate that the advances came from third parties but do not identify the third parties.

[7] The advances were converted during the subsequent event time period. If the reader is not familiar with the professional guidance regarding subsequent events, it will be helpful to review AS 2801 on subsequent events, available at: https://pcaobus.org/Standards/Auditing/Pages/AS2801.aspx

In November 2011, the company formed Obscene Interactive, a wholly owned subsidiary to identify trends in social media (OBJ 2012).

Table 2
Obscene Jeans Corporation (A Development Stage Corporation) Balance Sheets

Panel A: Balance Sheets	**2014**	**2013**	**2012**	**2011**	**2010**
Assets					
Cash	$491,256	$75,190	$2,652	$45,169	$41,761
Receivable	10,357				
Total Current Assets	501,613		2,652		41,761
Other Assets:					
Prepaid expenses	30,829			2,086	9,167
Deposits	13,886				
Fixed Assets:					
Furniture & Fixtures	12,388				
Accumulated Depreciation	(180)				
Total Fixed Assets	12,208				
Intangible Assets	2,187,251				
Accumulated Amortization	(143,792)				
Total Assets	$2,601995	$75,190	$2,652	$47,255	$50,928
Liabilities					
Accounts Payable	582,761	92,381	31,054	62,991	10,000
Advances Payable	633,160		280,372	590,353	
Current portion N. P.	731,220	76,311			
Total Current Liabilities	1,947,141	168,692	311,426	653,344	10,000
Convertible Notes Payable	840,749	41,642			
Total Liabilities	2,787,620	210,334	311,426	653,344	
Stockholder's Deficit					
Common Stock @ par	2,904	1,523	61	34	1,200
APIC	5,221,633	2,898,220	1,675,205	681,466	60,300
Accumulated Deficit	(5,410,162)	(3,034,887)	(2,174,586)	(1,287,589)	(20,572)
Total Liabilities & Stockholders' Deficit	$2,601,995	$75,190	$2,652	$47,255	$50,928
Panel B: Cash Flows					
NCF Operating Activities	(773,299)	(391,707)	(322,889)	(586,945)	(19,739)
NCF Investing Activities	(152,285)	0	0	0	0
NCF Financing Activities	1,341,650	464,245	280,372	590,353	61,500

Fiscal Year August 31, 2012

On May 9, 2012, OBJ entered into a joint venture[8] agreement with Source Street. The purpose of the joint venture was to fund the planning, development, and launch of online and mobile games. OBJ paid $5,000 to the joint venture upon signing the agreement and planned to

[8] A joint venture is an arrangement in which two parties pool their resources to accomplish a mutual objective. The joint venture is a separate legal entity.

make weekly payment of $1,500 for the term of the joint venture. OBJ agreed to share profits equally with Source Street. On July 9, 2012, the joint venture agreement was renegotiated and required weekly payments of $2,500. Profits and losses were to be split 80% to OBJ and 20% to State Street. Paul Watson (CEO) was still the only employee. On November 13, 2012, there was a 40-1 reverse stock split. Current investors were given 1 share of new stock for every 40 shares they were currently holding.[9] The shares the investors were holding prior to the reverse split were retired. The reverse stock split occurred after the fiscal year-end but prior to the issuance of the audit report dated November 29, 2011 (Note the decrease of the Common Stock @ par account on the 2011 balance sheet in Table 2) (OBJ 2012).

Fiscal Year August 31, 2013

In 2013, OBJ continued its move into online gaming. On July 20, 2013, the company entered into a joint venture agreement with Bluff Wars to develop the Android version of its existing game Bluff Wars. For the year ended August 31, 2013, OBJ reported no sales (see Table 1) and had $75,190 in cash on hand (see Table 2) (OBJ 2013).

Fiscal Year August 31, 2014

On May 21, 2014, OBJ entered into a joint venture agreement with Great Outdoors and created MyGO Games to operate the joint venture. The purpose of the joint venture was to expand the company's line of games. On June 23, 2014, OBJ changed its name to MyGO Games Holding Co. (MyGO). In 2014, the company reported its first sales revenue. The $753 of sales revenue was related to online games. At fiscal year-end, August 31, 2014, MyGO had cash on hand of $491,256 (see Table 2). The 2014 financial statements include a note stating that the company's ability to meet its short-term obligations is dependent upon the company's ability to secure additional debt or equity financing (OBJ 2014).

SUGGESTED QUESTIONS

1. OBJ sold stock to its CEO. This was noted in the financial statements as a related party transaction. Answer the following questions regarding related party transactions:
    a. What is a related party?
    b. What is the auditor's responsibility when a related party transaction is identified?
    c. What are the risks related to a related party transaction?

2. The case discussion identified two different subsequent events.
    a. What is the definition of a subsequent event per AS 2801?

[9] As with traditional stock splits, the total value of the company's stock is unchanged. However, due to a decrease in the number of outstanding shares, each individual share increases in value.

b. What are the two different types of subsequent events identified in AS 2801? OBJ reported two different subsequent events. According to AS 2801, which type of subsequent events did OBJ report?

3. The company changed from an apparel company to a social media/electronic game company. What concerns arise for the auditor when a company changes its business?

4. After years of reporting zero revenue, OBJE (after changing to MyGO Games) reported a small amount of revenue in 2014. Assume that the recognized revenue did not meet the revenue recognition criteria. How would PCAOB's guidance (see AS 2810, PCAOB 2017b, appendix B) on materiality (both the quantitative and qualitative) affect the auditor's consideration of the materiality of the revenue?

5. Due to the lack of sales, the auditor needs to consider issuing a going-concern opinion on the financial statements. Relative to the 2014 financial statements, answer the following questions related to a going-concern opinion (reviewing AS 2415, PCAOB 2017a will help answer this question).
   a. AS 2415.03a notes that the auditor should use the evidence gathered in and planning and testing the audit objectives and determine if in the aggregate the evidence indicates there could be "substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time". What conditions or events in the 2014 financial statements might indicate to the auditor that there is substantial doubt about the entity's ability to continue as a going concern?
   b. According to AS 2415.03b, if the evidence indicates that there is substantial doubt about the company's ability to continue as a going concern, the auditor should obtain information about management's plans to mitigate the doubt about the company being a going concern as well as assess the likelihood that such plans can be effectively implemented. As noted in the case narrative, managements' plans are to obtain debt and/or equity financing to meet the short-term obligations. List some audit procedures that the auditor might perform to gather evidence regarding the probability of success for management's plans.
   c. If the auditor determines that there is "substantial doubt about the company's ability to continue as a going concern for a reasonable period of time", what modification does the auditor make to the audit report?

REFERENCES

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