AUDITING ISSUES ENCOUNTERED WHILE AUDITING A DEVELOPMENT STAGE CORPORATION

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INSTRUCTORS' NOTES

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.

TEACHING APPROACH

The case has been used successfully in a class discussion format for an introductory auditing course. A nice feature of this case is that the 10-K reports for the company are quite short and easy to understand. The financial reports for a couple of the early years of OBJ can be projected to show students how it generated no revenue and had almost no assets other than cash. Emphasize that, incredibly, a company like this can continue to raise capital. Students will want to determine why investors would be willing to invest in this company after the first year or two. The notes for the financial statements are also relatively easy to read and understand, so it is worthwhile to read the notes regarding the ongoing concerns, subsequent events, and related party transactions. The 10-Ks are easily accessible on the SEC website. When searching on the website, it is easiest to search for the company name, Obscene Jeans Corporation). This search will also yield filings for the subsequent company, MyGO Games Holdings. The instructor can then present the questions and lead a discussion on the related issues. Alternatively, the class can be divided into groups, and each group can be assigned a question. Give the groups 30 minutes to research and discuss the answer, and then have the groups present their answer. The case can be done in 60 minutes when the instructor leads the discussion, and the entire lesson can easily fit into a 75-minute class when the student group approach is used.

ANSWERS TO 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?

        As a U.S. public company, the governing standard for the definition of related parties for OBJ is in Section 850 of the FASB Codification, which defines a related party as follows:

        Related parties include (FASB 2016, 850-10-20):

        a. Affiliates of the entity

        b. Entities for which investments in their equity securities would be required.

        c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

        d. Principal owners of the entity and members of their immediate families

        e. Management of the entity and members of their immediate families

        f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

        g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the

transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

As a member of management (see above), Ms. Stark Cappelli would be considered a related party, and therefore the stock sale to her would qualify as a related-party transaction.

b. What is the auditor's responsibility when a related party transaction is identified?

The auditor's objective in relationship to related parties is to understand the relationship with the related parties and to determine whether the transactions with related parties have been identified, accounted for, and disclosed in the financial statements (PCAOB 2017c).
Once a related party transaction has been identified, the auditor's overall concern is to address the risks of material misstatement caused by the related party transaction. The auditor should perform the following (not an exhaustive list):

Read the underlying documentation and evaluate the business purpose of the transaction.

Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures.

Determine whether any exceptions to the company's established policies or procedures were granted.

In the case of OBJ, the auditor should examine the documentation supporting the sale of stock to Ms. Stark-Cappelli. The auditor should ask about the business purpose of the transaction. In this case, it is easy to imagine that the purpose of the transaction was to raise some seed money to help forward the business plan. The risk of material misstatement would be low.

c. What are the risks related to a related party transaction?

Related party transactions create two types of risks. First, related party transactions increase the risk of material misstatement. The auditor should evaluate whether the transactions have been entered with the goal to engage in fraudulent financial reporting or to conceal misappropriation of assets.

Second, there is a risk that the related party transaction would not be accounted for and disclosed in an appropriate way.

One item of concern for the auditor in OBJ's related party transaction is the statement in the disclosure:

"…are not necessarily indicative of the terms and amounts that would have been incurred had comparable transactions been entered into with independent parties (SEC 2011).

It is important to note that companies have incentives to say that the related party transaction occurred on the same terms as a non-related party transaction. If management makes such an assertion, the auditor must evaluate the evidence and determine if the evidence supports such as assertion.

2. The financial statements identified two different subsequent events.
   a. What is a subsequent event?

Subsequent events are events or transactions that occur after the balance sheet date but prior to the issuance of the financial statements that have a material effect on the financial statements. The time period between the balance sheet date and the date of the auditor's report is referred to as the subsequent event time period. It is important to note that subsequent events are typically unusual or significant events or transactions. Most transactions that occur subsequent to the balance sheet date are not subsequent events and are appropriately reported in the following year's financial statements.

   b. What are the two different types of subsequent events? Which type of subsequent events did OBJ report?

The standards describe two different types of subsequent events. The first type (Type I) refers to "those events that provide additional evidence with respect to the conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements" (PCAOB 2017d).

The second type of subsequent event (Type II) refers to "those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date" (PCAOB 2017d).

The distinction between Type I and Type II subsequent events is important in determining how the subsequent event will impact the financial statements. Type I subsequent events require adjustment of the prior period financial statements in addition to disclosure. Type II subsequent events require only disclosure.

On November 13, 2012, OBJ enacted a 40-1 reverse stock split. The balance sheet was dated August 31, 2012, and the audit report for the August 31, 2012 financial

statements was dated November 29, 2011. The reverse stock split occurred subsequent to the date of the balance sheet but prior to the date of the audit report. As seen in Table 2, OBJ adjusted the Common Stock at Par account on the 2011 financial statements. Since OBJ adjusted the accounts on the 2011 financial statements in addition to disclosing the reverse stock split, it can be inferred that OBJ accounted for the reverse stock-split as a Type I subsequent event. This seems to be a questionable interpretation of the guidance on subsequent events. Type I events specifically mention that Type I events are related to estimates. The common stock for the par account is not an estimate. Additionally, AS 2801.06 (PCAOB 2017d) specifically mentions the issuance of new stock as a Type II event.

On September 26, 2011 (during the subsequent event time period for the 2010 financial statements), OBJ converted some of the advances into convertible notes. OBJ disclosed this conversion in the 2010 financial statements as a subsequent event. OBJ did not adjust the amounts in the 2010 financial statements based on this conversion. Since OBJ only disclosed this event and did not adjust the financial statements, OBJ concluded that this was a Type II subsequent event. This is consistent with the guidance given in AS 2801 (PCAOB 2017d).

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

Companies are allowed to change the line of business in accordance with their corporate charter. From the auditor's perspective, one concern relates to disclosure. The company needs to disclose the change of business along with the resulting risks accompanying the change in the financial statements. Additionally, the auditor should consider adding an explanatory paragraph to the auditor report to emphasize to the users of the financial statements that the business model has changed.

In the case of OBJ changing from an apparel company to a gaming company, the company did disclose the change in the financial statements. The auditor did not add an explanatory paragraph to the auditor report to emphasize this change. The choice to add or not add an explanatory paragraph is made according to the auditor's judgment.

4. After years of reporting zero revenue, OBJ (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 the 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?

As noted in Table 1, after four years of reporting no revenue, in 2014, MyGO Games reported revenue of $753. While this amount would normally be considered immaterial

on a quantitative basis, for a company reporting a loss of $2,375,275 for 2014, the auditor should note that some amounts and disclosures may be considered material due to qualitative factors (PCAOB 2017b). In this case, reporting revenue in 2014 breaks a four-year trend of reporting zero revenue. Therefore, the auditor should treat the $753 as material due to the qualitative importance of the company going from reporting zero revenue to positive 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?

       From Table 1 and Table 2 we know the auditor would have gathered evidence that would show that the company's NCF from operating activities for 2014 were ($773,299) which was almost twice as large as the prior year's (391,707). While the cash on hand for 2014 was $491,256 was a significant increase from the prior year, the current liabilities of $1,947,141 is a greater than ten-fold increase from the current liabilities from 2013. The company's working capital for 2014 is ($1,445,528). Given the company's small amount of sales in 2014 ($753), the ability of the company to meet's its short term obligations will be dependent on its ability to raise capital from borrowing or issuing stock. Given the uncertainty about future sales, these factors would raise substantial doubt about the company'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.

       The auditor would focus on gathering evidence regarding the feasibility of management obtaining sufficient financing to meet the short-term obligations of the company. Some possible audit procedures could include:

- Inquire of management whether they have had any discussions with potential lenders and/or investors. If so, have management disclose to the auditor the names of the creditors and/or investors.
- The auditor could review the company's current debt agreements to determine if additional borrowings would violate the terms of the debt.
- The auditor could request to have a meeting with the potential investors and creditors to gauge the probability that they would be willing to extend financing to the company. If the investors and/or creditors have made commitments for future financing, the auditor could use written confirmations to confirm the details of the financing arrangements.
- The auditor could review the minutes of the board of director's meetings to see if a discussion regarding future financing has taken place and identify any issues that were discussed.
- The auditor could inquire of the firm's legal counsel regarding any discussions between the legal counsel and entities that may provide financing.
- The auditor could review subsequent events to determine if any events subsequent to the date of the financial statements could impact the probability that the company could be a going concern.

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?

If the auditor determines that substantial doubt about the company's ability to continue as a going concern is present, the auditor should add an explanatory paragraph to the audit report. The explanatory paragraph should describe the uncertainty and should use the phrases "substantial doubt" and "going concern" (AS 2415.12, PCAOB 2017a). AS 2415 provides the following example paragraph as a guide:

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Fiscal Year 2015 and Epilogue

MyGO Games filed its last financial statements (unaudited) with the SEC for the 9 months ending May 31, 2015. During these 9 months, MyGO Games reported sales of approximately $27,000. On Sept. 3, 2015, a news article detailed how OBJ/MyGO was one of 10

OTC stocks that was controlled by a group of financiers who used a pump-and-dump strategy to profit from stock sales (Van Velzen 2015). These insiders would advance money to the companies and then convert the advances to convertible notes with attractive conversion features. The individuals holding the convertible notes would immediately convert the notes into shares and dump the shares on the market before unwary investors were aware of what was happening. To deal with the increasing number of issued shares, the companies would employ reverse stock splits such as the 40-1 reverse stock split employed by OBJ. Based on this news report, it appears that OBJ was focused on making money for a handful of insiders using the pump-and-dump strategy and never intended to produce jeans.