

## **Auditing an Acquisition: A Case Study**

Magdy Farag  
California State Polytechnic University, Pomona

### **ABSTRACT**

This auditing case provides students an opportunity to understand one of the different purposes of an independent audit, which is an audit of financial statements for acquisition decisions. Although the central theme of this case is the acquisition transaction, students get to understand the operations of an e-commerce business and how it is structured. The case is designed for accounting students to understand the important information that auditors focus on when planning an audit for acquisition purposes, and to assess the risk factors related to acquisitions. This case is developed to be used in upper-division auditing courses. However, the case can also be used in graduate level auditing courses.

Keywords: audit planning, acquisition, startup, investment, e-commerce.



Copyright statement: Authors retain the copyright to the manuscripts published in AABRI journals. Please see the AABRI Copyright Policy at <http://www.aabri.com/copyright.html>

## INTRODUCTION

In June of 2019, Babysitter, Inc., a large publicly traded company, started negotiating the acquisition of Toddlers Lane, Inc., a startup internet company. Toddlers Lane is a company that provides care packages of baby products that are delivered to consumers on a recurring monthly basis. These care packages include toys and other educational material that are age suitable for children up to the age of five years old. Packages are delivered to consumers that subscribe to their care package program. The company started in August of 2014, but as many startup companies, it incurred significant operating losses. Nonetheless, its customers' base increased significantly during its four years of operation. This increase in the number of customers was reflected in a remarkable increase in its sales revenue that showed a huge growth potential, which made it an attractive acquisition for Babysitter that is also growing through the acquisition of several successful smaller companies.

Since its inception, the company was highly leveraged with loans from close family members to the founder of the company, Maria Forster, as well as a couple of virtual capital funds (GNC Capital and Armlock Capital). The company needed additional funds to support current operations, and the acquisition of the company by Babysitter created an attractive opportunity for Forster to reap the benefits of her substantial effort in developing the company and to pay back the debt she owed to her family and to the virtual capital funds.

McLawrence, LLP, a large national CPA firm, is hired by Babysitter to conduct an audit that can provide the company with an independent audit opinion about the financial statements of Toddlers Lane before it acquires it. McLawrence needs to complete the audit within a three-month period so that the company's attorney can initiate the legal requirements of the acquisition. Toddlers Lane has never been audited before; however, the company's founder is somewhat prepared for an audit fieldwork, and the company's Director of Finance is also ready to provide the last three years financial statements, related disclosures, and all accounting documentation.

## THE COMPANY BACKGROUND

Maria Forster is the founder and CEO of Toddlers Lane. After earning her undergraduate degree in computer science and a Master of Business Administration (MBA) degree in one of the prestigious private universities in San Francisco, Maria began her e-commerce career as a product manager during the early days of the internet. Throughout her fourteen years career, she has held leadership positions and handled major product and social media initiatives at leading technology companies all over the Silicon Valley. She also served on the board of a startup communication company that was acquired by a large national internet service providing company. In Fall of 2014, she left her employer to follow her entrepreneurial dream and start her own company. Remembering how exhilarating and exhausting it was to be a first-time mom, her vision was to create an e-commerce company that could make parents' life easier and help them make healthy product choices for their families. And that's how Toddlers Lane came to be.

The company does not have a CFO. The highest-ranking finance employee is Lihan Peng. Lihan has served as the company's Director of Finance and Analytics since September 2016. She previously served as an analyst with one of the company's venture capital funds. Even though her entire professional experience is only limited to six years, she has adequate knowledge about the company and good understanding of accounting and reporting.

The company has three other employees who update the company's website, advertise the services through social media and other internet channels, send orders to third party warehouses that send packages to customers, and handle customers' questions. All three employees are business graduates with experience ranging from two to four years.

The Board of Directors is comprised of Maria Forster (CEO), Jeffrey Johnson (of GNC Capital), and Larry Brown (of Armlock Capital). Jeffrey and Larry have professional experience appropriate to serve on the Company's board. Jeffrey has over 20 years of executive experience and serves on the boards of other technology companies and is active in investments made by the fund for which he is the Managing Partner. Larry was previously the CEO of a large internet corporation, and currently he is a partner at Armlock Capital. Lihan, the company's Director of Finance and Analytics, previously worked as an analyst at one of the virtual capital funds (Armlock) under one of the company's board members (Larry Brown). Due to the small size of the board, the Company does not have an Audit Committee of the Board of Directors.

## **OPERATIONS OF TODDLERS LANE**

The Company was founded in Fall of 2014, in Mountain View, California. The Company's primary product offering consists of compiling and selling surprise packages for new mothers and mothers of children up to five years old. These surprise packages contain an assortment of goods (i.e., toys, lotions, books, etc.), and are available for purchase on a one-time basis, or on a multi-month subscription basis (i.e., three, six, or twelve months), whereby customers receive a different box each month during the subscription period. At the end of each subscription term, customers are automatically renewed for another term (i.e., same number of months as original subscription), although customers also have the option to cancel the renewal.

In addition to box sales, the company also offers additional products on an individual basis via its online shop; and in May 2017, the Company introduced the "add-to-box" concept, whereby customers can purchase individual items to be included with their monthly boxes and not incur additional shipping charges.

## **THE AUDIT BY MCLAWRENCE LLP**

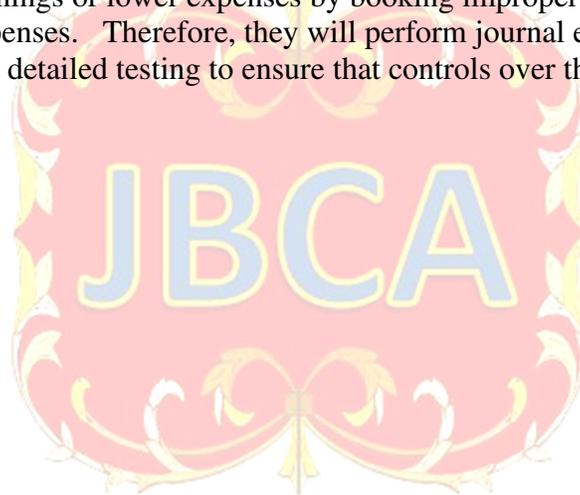
Toddlers Lane is in the late startup/early growth phase. The CEO has been focused on growing operations in fiscal year 2018 and continuing in fiscal year 2019. She has also been involved and is expected to close the sale of the company to a third-party company (Babysitter, Inc.) in early July 2019. The audit firm, McLawrence, believes that there might be an incentive for the CEO to make operations look better (i.e., increase revenues and assets, or decrease expenses and liabilities) to make the company more attractive to the buyer and increase the acquisition price. McLawrence audit team will test the completeness of expenses and liabilities as well as the cutoff and existence of revenue and assets to ensure they are not overstated. The audit firm will also perform testing of payroll and other operating expense accounts to determine if there are any material understatement.

During the initial fieldwork, McLawrence audit team noted that there is a shortage of accounting staff with only the Director of Finance, Lihan Peng, and her part-time assistant. Due to this shortage, the company outsources most of its controller and accounting work to a third-party accounting firm to perform the necessary accounting tasks. Lihan reviews all work performed by the accounting assistance she receives each month. While she is not an

experienced controller and not completely competent in GAAP accounting, she does perform a high level review of amounts entered into the system. The audit team also notes that cash is not handled by the third-party accounting firm and generally all cash received is from third party credit card companies. Lihan Peng and Maria Forster are the two check signers, and they both review all payments prior to processing. Thus, there does not appear to be a high risk of opportunity related to cash misappropriation.

The audit team also believes that there are enough controls in place to limit the opportunities to commit fraud. Further, the CEO and top-level management are actively involved via board meetings and in operations. All accounting and finance activities have a top-level review process, and misappropriation of assets are unlikely with the processes and amount of transactions for cash, inventory, and fixed assets. Most of the company's inventory is held at third-party warehouses, which are managed by the third party with periodic counts by the company to ensure that inventory levels are within reason.

Although management is made up of competent personnel, the company has limited control efforts related to financial accounting and reporting. For example, all manual journal entries appeared to be reviewed by Lihan Peng. The audit team believes that management has the ability to increase earnings or lower expenses by booking improper cutoffs and fictitious entries to revenues or expenses. Therefore, they will perform journal entries testing and revenue/deferred revenue detailed testing to ensure that controls over the recording of journal entries are proper.



## CASE QUESTIONS

1. Identify significant factors that make Toddlers Lane an attractive investment for Babysitter, Inc.
2. Based on your understanding of Toddlers Lane and its business environment, identify risk factors unique to this industry that McLawrence audit team should consider (Refer to AICPA, AU-C 315, 2019).
3. What additional information is needed by McLawrence audit team to be able to conduct their audit?
4. Given the information provided, and the additional information you recommend the audit team to collect, develop an audit plan to assist in completing the audit on time (Refer to AICPA, AU-C 300, 2019).



## TEACHING NOTES

This case study is developed for use in upper-division auditing courses. However, the case can also be used in graduate level auditing courses.

### Discussion Questions and Answers

1. Identify significant factors that make Toddlers Lane an attractive investment for Babysitter, Inc.

There are multiple factors that make Toddlers Lane an attractive investment for Babysitter, Inc. As stated in the case, Toddlers Lane is currently in its “late startup/early growth phase” that creates a strong profit driven implication for Babysitter, Inc. as Toddlers Lane has already absorbed much of the startup costs and time to establish their client base and business model. Moreover, Toddlers Lane has experienced a consistent growth during its four years of operations, which was reflected by a significant increase in its sales revenue. In addition, the company has a huge growth potential grounded on the implementation of new ideas such as the “add-to-box” concept. This can be perceived as an industry that stays consistently profitable in the long run as the company has established an online presence through their own website, social media, and other internet channels. Also, the company has established strong affiliation with third-party warehouses and suppliers to assist in maintaining their business operations. All these factors make Toddlers Lane an attractive acquisition for Babysitter, Inc.

2. Based on your understanding of Toddlers Lane and its business environment, identify risk factors unique to this industry that McLawrence audit team should consider (Refer to AICPA, AU-C 315, 2019).

AU-C 315 covers understanding the client’s business industry and its environment and assessing the risks of material misstatement, whether due to fraud or error. An important ingredient of understanding the business industry and its environment is to obtain an understanding of the nature of the business, including its operations; ownership and governance structures; and the way the business is structured and how it is financed. Based on the case information, there are some risks in Toddlers Lane industry that McLawrence should consider when performing its audit. As a startup company, one of these risks is the possibility of trying to make operations look better by inflating revenues and understating expenses. Toddlers Lane does not have an official CFO or a controller, so McLawrence should properly test if revenues and expenses were appropriately recognized and recorded in the proper period due to lack of financial expertise on the accounting side of the company.

Most startup companies experience net losses in their early years of operations, and may purposely overstates revenues and understate expenses to lower the amount of losses reported. This is particularly true for Toddlers Lane because they automatically enroll prior customers into new subscription plans. If a customer cancels a subscription, Toddlers Lane might delay the recording of the cancellation. By delaying the cancellation of customers’ subscriptions, the company’s revenues will be inflated, and Toddlers Lane may appear more desirable to Babysitter, Inc.

Another risk factor that should be considered as part of the audit of Toddlers Lane is how the company outsources many of its operations, such as inventory management and its accounting functions. Despite outsourcing most of their accounting functions with a third party, there may be an incentive for the Director of Finance, Lihan Peng, to collude with the third-party accounting firm in making the company appear more profitable. The same can be said regarding inventory, because although it is outsourced to a third-party, the inventory is still counted by Toddlers Lane's employees, and there is not much that can stop the company from overstating inventory measurement and reporting lower cost of goods sold. The fact that Toddlers Lane only has few employees may lead to the assumption that collusion among employees and management is a possibility.

3. What additional information is needed by McLawrence audit team to be able to conduct their audit?

The purpose of this question is to encourage students to think of the important information that should be addressed in auditing an acquisition. While students will come up with many additional information needed by the auditor to conduct the audit, it is important for them to consider whether the information are cost beneficial. In order for an audit to be successful, the McLawrence will need some additional information that are not provided in the case. The auditor is assumed to have access to the journals, ledgers, trial balances, and financial statements of Toddlers Lane. McLawrence's auditor will want to verify the company's bank accounts, bank statements, and signatures authorized with the bank. This will help the audit firm determine how much cash Toddlers Lane has, who controls the cash, and the types and amounts of expenditures made by the company. The auditor will also need to check the loan contracts for the funds Toddlers Lane received to start its operations, and the articles of incorporation of the company to verify how it is governed and what rules are in place. Access to meeting minutes of the board of directors is also needed to see the board's discussions and decisions being made. Finally, the auditor will need information of third-parties that outsource their inventory handling and their accounting work to ensure the legitimacy of their work.

4. Given the information provided, and the additional information you recommend the audit team to collect, develop an audit plan to assist in completing the audit on time (Refer to AICPA, AU-C 300, 2019).

After obtaining sufficient information about the client, the audit team should plan the audit engagement. AU-C 300 addresses the auditor's responsibility to plan an audit in recurring audit and also in an initial audit engagement. Students should be aware that there are additional considerations for the auditor in initial audit engagements. The auditor will need to expand the planning activities of the audit because the auditor does not have the previous experience with the client that is considered when planning recurring engagements. Some of the additional matters that the auditor may consider in establishing the overall audit plan include: discussions with the predecessor auditor in regards to working papers, discussions of any existing major issues with management, audit procedures necessary to obtain sufficient appropriate evidence for the opening balances, and other procedures required by the client's quality control system that the auditor is not aware of.

In Toddlers Lane audit, the first step that McLawrence must perform is to create an audit team that is familiar with the industry in which Toddlers Lane operates. The audit team will then start the planning activities. These activities range from establishing the overall audit strategy to the details of audit programs that will be implemented. The audit team needs to review updates in Toddlers Lanes industry as they might not be familiar with new regulations in the e-commerce industry and the accounting standards related to subscription revenues. The audit team will also be required to conduct preliminary analytical procedures. The audit team will then need to set materiality thresholds for the audit and conduct performance materiality for different audit segments. Since Toddlers Lane have shown significant increase in revenue, The audit team should be very skeptical of its revenue and expense recognition, as well as assets valuation. McLawrence audit team will then identify significant risks due to fraud or error. Since the business is new, there is a high risk of error. McLawrence audit team should spend more time to assess inherent and control risks. Inherent risk is considered high since the company is relatively new and operates in an inherently risky environment. Internal controls are also very limited due to the size of the company. Finally, the overall audit strategy and the audit plan should be documented to help the audit team start the testing phase of the audit.



**REFERENCES**

- American Institute of Certified Public Accountants. (2019). Planning an audit. AU-C Section 300. *New York: American Institute of Certified Public Accountants.*
- American Institute of Certified Public Accountants. (2019). Understanding the entity and its environment and assessing the risks of material misstatement. AU-C Section 315. *New York: American Institute of Certified Public Accountants.*

