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Scott Jackson
University of South Dakota, scott.c.jackson@usd.edu

Paul Ordyna
University of South Dakota, paul.ordyna@usd.edu

Srinivasan Ragothaman
University of South Dakota, Srini.Ragothaman@usd.edu

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A COVID related fraud at Applied BioSciences Corp.: What are the Lessons?

SCOTT JACKSON*
University of South Dakota
scott.c.jackson@usd.edu

PAUL ORDYNA
University of South Dakota
paul.ordyna@usd.edu

SRINIVASAN RAGOTHAMAN [intended presenter]
University of South Dakota
srini.ragothaman@usd.edu

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* Corresponding author: 414 E Clark St, Vermillion, SD, 57069. scott.c.jackson@usd.edu

A COVID related fraud at Applied BioSciences Corp.: What are the Lessons?

ABSTRACT

This case is based on fraudulent COVID-related press releases by Applied BioSciences Corp. (APPB) in a "pump-and-dump" scheme, and the related SEC complaints. In this case study, students assume the role of an external auditor and become familiar with several auditing and intermediate accounting concepts, including: fraud, ethical reasoning and utilitarian principles, fraud red flags and fraud risk assessment, accounting for goodwill, accounting for intangibles, SEC investigations, and regulation. Students at an accredited Midwestern University participated in this case. We provide assessment information and implementation suggestions to interested instructors. Student feedback was positive about the learning outcomes of this case.

Keywords: COVID-19 fraud; fraud risk factors; ethical reasoning; utilitarian ethics; accounting for intangibles; horizontal and vertical analyses

Case Introduction

On May 14th, 2020, the Security and Exchange Commission (SEC) announced charges against Applied BioSciences for making false statements about offering and shipping coronavirus test kits to the general public to combat the spread of COVID-19 (*SEC v. Applied BioSciences Corp*, 2020). As news of the COVID-19 outbreak dominated headlines throughout the globe, Applied BioSciences issued press releases to announce that it was shifting its manufacturing resources from development of synthetic cannabinoid therapeutics/biopharmaceuticals to the manufacturing of products that would help battle the spread of COVID-19. On March 25th, 2020, the company first announced it would create and sell through an affiliate a new hand sanitizer (Applied BioSciences Corp. 2020a) and then, on March 31st, 2020, the company announced it began shipping Coronavirus Test Kits to the general public for private use (Applied BioSciences Corp., 2020b).

As a result of these press releases, Applied BioSciences' stock price and trading volumes increased significantly. As a result of the March 31st press release, Applied BioSciences stock price increased from $.45 per share to $.80 per share and the share volume increased from 1,600 on March 30, 2020, to a volume 136,300 on the date of the release (See Figure 1). On April 13, 2020, the SEC suspended the trading of the company's stock for 10 days because questions arose concerning the accuracy of Applied BioSciences public statements and the company's ability to distribute tests where the technology had not been approved by the FDA for home use (SEC 2020c). In an April 24th press release, Applied BioSciences announced that it had terminated its agreement with its supplier for COVID-19 test kits and said that it had not distributed, and would not be distributing, test kits (Applied BioSciences Corp. 2020c). The company also defended its

March 31st press release, stating that at the time of the release, the FDA did not disallow the use of the test kit for home use without the administration of the test by a qualified medical professional, but that by April 1st, the FDA had notified the test kit supplier that home use was not allowed.

In its complaint, the SEC alleged that Applied BioSciences misled the public by stating that it was diverting manufacturing resources when in fact it did not, by claiming it had "begun shipping" the COVID-19 home test kits when in fact it did not, and by failing to disclose that the FDA had not approved a COVID-19 test kit for home use at the time of the public disclosure (*SEC v. Applied BioSciences Corp*, 2020). The complaint alleged that Applied BioSciences knew or was reckless in knowing that the test kits were subject to FDA review and that no test kit for home use had been approved by the FDA at that time. The materially misleading nature of these press releases suggests that Applied BioSciences was seeking to exploit the COVID-19 pandemic for profit.

Company Overview

From its inception, Applied BioSciences had trouble trying to figure out its business model. The company was co-founded by Colin Povall and Scott Stevens in 2014 as First Fixtures, Inc. with the intention to become an online shopping mall specializing in the sale of bathroom and kitchen fixtures and faucets. A little over two years later, the company completed a reverse merger with Stony Hill Ventures, changed its name to Stony Hill and started to develop and sell cannabis therapeutics. Soon after, the company amended its articles of incorporation again to change its name to Applied BioSciences Corporation.

The cannabis industry presented some challenges to the company. Currently, the use, sale, and possession of cannabis products are illegal under U.S. federal law (16 USC § 559b). From a federal tax perspective, Applied BioSciences is prohibited from deducting any expenditures related its cannabis products on the company's income tax return under the I.R.C. tax code (26 USC § 280E). Additionally, most big banks still refuse to work with cannabis companies because banks are required to file reports to the federal government detailing a customer's suspicious or illegal activities. Since marijuana is still illegal at the federal level, banks are required to file these reports. This compliance can be costly to banks. Also, almost half of Applied Biosciences' working assets come from accounts receivable suggesting that cannabis customers are not as reliable in paying their bills. Finally, mounting losses and an auditor's opinion that expressed doubts about the company's ability to continue as a going concern weighed on Applied BioSciences.

Fraud

An opportunity to reinvent itself came to Applied BioSciences with the beginning of the COVID-19 pandemic. The company decided to shift its focus from cannabinoid-based products to pandemic-related products, when it announced on March 25, 2020, that the company was dedicating resources to build products that would help battle the spread of COVID-19, including hand sanitizer (Applied BioSciences Corp. 2020a). This announcement came as a surprise to the market and created confusion among some investors. Upon Applied BioSciences announcement, one investor wrote in the company's Yahoo! conversations form, "The Coronavirus has caused major stores run out of Hand Sanitizers, So $APPB stock recently launched a CBD hand sanitizer product line. Price move in the range of $1.95 to $2.10 anticipated with $APPB shares". Another commentator inaccurately stated, "$APPB mj stock selling and shipping CBD infused Hand

Sanitizers" (Yahoo! Finance, 2020). One week later, the company announced it had begun shipping Coronavirus Test Kits to the general public for private use (Applied BioSciences Corp. 2020b). Figure 1 illustrates the closing stock price and trading volume for APPB for the period in question and highlights the increased stock trading activity surrounding the announcements. On March 31, 2020 (day of first press release), APPB's stock price increased almost 80 percent from the previous day (from $0.45 to $0.80), and its volume increased 85 times (136,300 shares sold, versus 1600 shares sold on the previous day).

[INSERT FIGURE 1 HERE]

Around this same time, the SEC's Division of Enforcement had formed a Coronavirus Steering Committee to coordinate and oversee the Division's response to COVID-19 related misconduct (SEC 2020a, 2020c). The creation of this committee was a result of the lessons the SEC learned from previous public health crises and emergencies such as Hurricane Katrina in 2005 and the Ebola crisis of 2014 where some publicly traded companies would make fraudulent claims of treatments or disaster-response capabilities that were designed to unfairly profit from these events. As a result of the Committee's efforts, there was a surge of disclosure-related enforcement actions at the beginning of the pandemic mostly directed towards micro-cap companies like Applied BioSciences. These enforcement actions sent the message to publicly traded companies that the SEC intended to respond to COVID-related matters swiftly to protect investors.

Ultimately, the U. S. District Court for the Southern District of New York entered a final judgment against Applied BioSciences with respect to the company's misleading claims (*SEC v. Applied BioSciences Corp*, 2020). While Applied BioSciences did not admit to or deny the allegations of the SEC, the company consented to the entry of a final judgment restraining it from future violations of Section 10(b) of the Securities Exchange Act of 1934 and paid a $25,000 civil penalty (SEC 2020d).

Aside from the federal action by the SEC, Applied BioSciences also faced state and local enforcement actions. For example, the city and county district attorneys of Los Angeles, CA jointly brought an action against Applied BioSciences for "unlawfully advertising and selling an in-home COVID-19 antibody blood test that has not been approved by the Food and Drug Administration (FDA)" (*People of the State of California v. Applied BioSciences Corp.*, 2020; Feuer, 2020). Similar to the SEC, these local law enforcement entities made efforts to discourage COVID-19 related scams from the beginning of the pandemic. For the city and county of Los Angeles, they started a campaign to protect their local citizens from these scams. As opposed to the SEC's motivation to primarily protect investors, these local efforts seemed to focus more on protecting the health and safety of the local population. For example, L.A. district attorney George Gascon highlighted the importance of public health in his comments about the action against Applied BioSciences. He said, "the harm is not only financial, but also potentially deadly. Victims, who received false negative test results, may fail to seek treatment and fail to quarantine, contributing to the spread of the disease. Meanwhile, those with false positive test results may seek unnecessary treatment, burdening our already strained healthcare system" (Feuer, 2020). Applied BioSciences settled with the city and county of Los Angeles by complying with an injunction prohibiting the

sale of unapproved tests, paying full restitution to those who purchased the test and paying a $50,000 civil penalty (Feuer, 2021).

Aftermath

As a result of the enforcement actions, APPB's normal business operations appear to have slowed down, although the company website is still functioning. As of September 2022, when this case was written, the company's stock price was valued at $0.0025 per share. APPB has not issued any public press releases since April 2020 when it corrected its fraudulent COVID-related press releases.

Case Questions

Please study the case carefully. You may also review Income Statements and Balance Sheets of Applied BioSciences Corp. Bullet point (complete sentences) answers are ok. You may review the SEC complaint also.

(1) Who were all affected by the fake COVID-19 press releases by Applied BioSciences Corp. (APPB)? How were they affected? Please read about "Utilitarianism" in your auditing text –[Answer in a table format is fine.] "How" column should be short sentences.

(2) Please review the Income Statements and Balance Sheets for 2018 and 2019 for APPB at the end of this case. Perform multiple analytical procedures (key ratio analysis) on Income Statement and Balance Sheet numbers for 2019 and 2018. What conclusions can you draw from each of the analytical procedure?

(3) Describe various fraud red flags (under three categories: incentives, opportunities and rationalization) that are present in this Applied BioSciences Corp. case study. Detailed bullet point (should be complete sentences) are fine.

(4) Perform a horizontal analysis on the Balance Sheet and Income Statement data comparing the years 2018-2019. This is best done in Excel, with two columns, one listing the dollar amount of change between the two years for a single account, and one listing the percentage difference of that change over the first-year amount. Which accounts stand out to you?

(5) In general, when is goodwill recognized? How did Applied BioSciences compute goodwill? What amounts went into that computation? Comment on the acquisition of Trace Analytics. What accounts are impacted by this acquisition? Was the acquisition in the best interest of the company? You may reference the section in chapter 12 on goodwill for help answering the first part of this question.

(6) Calculate the gross profit margin percentage relating to "product" for 2018. Use that percentage to estimate the product cost of revenue and product gross profit margin for 2019. Compare that estimate to the actual product gross profit margin percentage for 2019. How does Applied BioSciences explain this discrepancy?

(7) Explain what is driving the $2.1M G&A expense in 2019, and whether the increase over 2018 is appropriate (HINT: as part of your discussion, consider the nature of fixed versus variable costs). How does Applied BioSciences explain this increase? How is your assessment of this account impacted by the knowledge of the fraud perpetrated by Applied BioSciences (see the SEC complaint and SEC resolution)?

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CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

The authors developed an instructional case based on an actual event that occurred at Applied BioSciences Corp. We did not add any fictitious information to improve the learning objectives. Instructional cases offer students an opportunity to apply accounting rules and to develop judgement in courses such as intermediate accounting and auditing. Developing these skills are important to accounting majors to perform well in their entry-level jobs. This case permits accounting students to study the details of a fraud that occurred at a publicly traded company during the early stages of the COVID pandemic.

Learning Objectives

This case can be used in auditing and intermediate accounting classes. This instructional tool was developed to increase students' skills in analysis, interpretation, and evaluation of real-world financial data.

The specific learning objectives for this case project are as follows:

- Apply Utilitarian ethical reasoning
- Understand accounting for goodwill
- Understand accounting for intangibles
- Evaluate fraud risk factors (AU 316)
- Design analytical procedures
- Perform vertical and horizontal analyses on real company data
- Governance in a publicly traded company
- Going concern evaluation

Implementation Suggestions

This case was used in undergraduate in auditing and an intermediate accounting classes. It is recommended that students be familiar with the following topics prior to completing the case: fraud, Code of Professional Ethics, generally accepted auditing standards, professional skepticism, goodwill accounting, and accounting for intangible assets. All seven questions were not assigned in any one class. Intermediate students were assigned questions 4, 5, 6 and 7, whereas auditing students were assigned other questions, namely 1, 2 and 3.

The case was presented to students via an email. The instructor selected group members randomly and this method of group selection matches the work environment. Student groups of 3 members per group seemed to offer participation opportunity to everyone. Students were required to read the case and answer questions through discussion with their group members outside of class time. Students were allowed ten days to two weeks to work through the case questions and submit their group answer to the instructor.

Assessment of Student Learning

This case was assigned during the Fall and Spring of 2021 to students in auditing and during the Fall of 2021 to intermediate accounting students. Only two to three questions were used at a time. Students had a good understanding of the case and the majority of participants provided responses that were consistent with the solution. Auditing students applied the Utilitarian ethical principles and came up with several groups/parties that were affected by this fraud and explained how they could be affected. Auditing students completed this case in groups outside of class and were able to perform several analytical (ratio comparisons) procedures and make useful inferences. They were also diligent in identifying fraud risk factors under three

categories: incentives, opportunities and rationalization. Intermediate accounting students were able to accurately perform a horizontal analysis on Applied BioSciences' financial statements and perform ratio analyses to identify potential red flags. Additionally, they were able to accurately define goodwill and critically analyze Applied BioScience's acquisition of Trace Analytics. In general, intermediate accounting students were able to analyze the consolidated financial statements and provide well-reasoned financial analysis of the company in light of the SEC complaint.

Additional Case Assessment

As the focus of the questions differed slightly for the two groups of students, we discuss their perceptions and feedback separately. Table 3 summarizes students' perceptions and feedback to the case. Table 4 lists a sample of student comments about the case. Table 3 indicates that auditing students responded, in general, favorably to the use of the case as a class assignment in the auditing class. A big majority of students either agreed or strongly agreed that completing the case helped them better understand the following concepts: red flags related to fraud, ethical reasoning, horizontal and vertical analysis (analytical procedures), and AU 316 (AICPA). A high percentage of students judged the level of difficulty associated with the case to be appropriate for a senior-level auditing course. Students were strongly in agreement that doing this case as a group project was beneficial. A large majority of students were of the opinion that this case was a useful learning tool.

Table 3 also summarizes intermediate accounting students' perceptions and feedback to the case. Similar to auditing students, intermediate accounting students also responded favorably to the use of the case as a class assignment in the intermediate accounting class. A large majority

of students either agreed or strongly agreed that completing the case helped them better understand the following concepts: acquisitions and goodwill computation, horizontal and vertical analysis (analytical procedures), the use of note disclosures in financial statements. A high percentage of these students judged the level of difficulty associated with the case to be appropriate for an intermediate-level accounting course. Some intermediate accounting students were appreciative that this was a group case, while others felt that this case could be better handled as an individual assignment. A large majority of students viewed this case as a useful learning tool. Table 4 lists a small sample of student comments about the case.

[INSERT TABLES 3 AND 4 HERE]

CONCLUSION

Undergraduate auditing and intermediate accounting students participated in solving this case. Given the pervasive impact of the COVID-19 pandemic, students felt a certain level of personal connection with the assignment, compared to other fraud cases. Because it is based on a COVID fraud that occurred at a publicly traded micro-cap company students had access to material on the financial press and were motivated to analyze this case. Students enhanced their critical thinking and professional judgment, by developing detailed group answers for several key questions on ethical reasoning, identification of fraud risk factors (AU 316), horizontal and vertical analyses, analytical procedures, accounting for goodwill and intangible assets. The case was analyzed by students working in teams and as such developed useful interpersonal skills as well.

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Figure 1. Applied BioSciences Corp. (APPB) Stock Performance

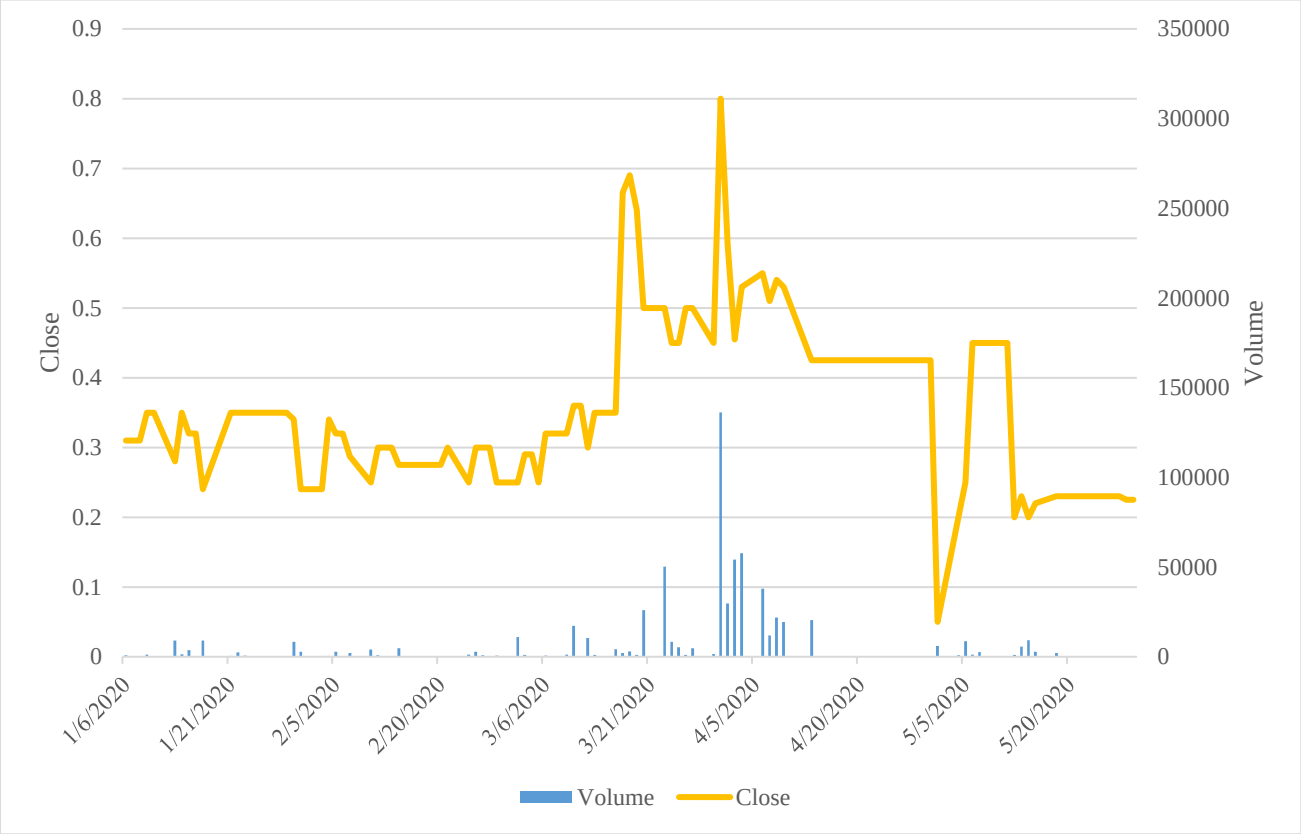

Table 1. Balance Sheet

CONSOLIDATED BALANCE SHEETS - USD ($)	Mar. 31, 2019	Mar. 31, 2018
Current Assets		
Cash	$47,044	$60,934
Accounts receivable, net	163,405	12,386
Inventory	78,737	29,074
Prepaids and other current assets	65,273	124,455
Total Current Assets	354,459	226,849
Property and equipment, net	452,048	4,441
Equity investments	898,292	468,537
Goodwill	1,941,149	
Other asset	5,500	5,500
TOTAL ASSETS	**3,651,448**	**705,327**
Current Liabilities		
Accounts payable	278,546	21,846
Note Payable	25,000	
Accrued expenses	70,720	14,039
Total Current Liabilities	**374,266**	**35,885**
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock; $0.00001 par value; 5,000,000 shares authorized; none issued and outstanding at March 31, 2019 and 2018		
Common stock; $0.00001 par value; 200,000,000 shares authorized; 13,397,110 and 10,499,610 issued and outstanding at March 31, 2019 and 2018, respectively	135	105
Additional paid in capital	6,892,242	3,054,297
Common stock to be issued, 408,805 and 263,000 shares at March 31, 2019 and 2018, respectively	773,807	526,000
Accumulated deficit	-5,531,260	-2,901,933
Total Applied BioSciences Corp. Stockholders' Equity	2,134,924	678,469
Non-controlling interest	1,142,258	-9,027
Total Stockholders' Equity	**3,277,182**	**669,442**
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	**$3,651,448**	**$705,327**

Table 2. Income Statement

CONSOLIDATED STATEMENTS OF OPERATIONS - USD ($)

	12 Months Ended	
	Mar. 31, 2019	Mar. 31, 2018
REVENUE, NET		
Products	$543,970	$197,554
Services	163,092	
Total revenues, net	**707,062**	**197,554**
COST OF REVENUE		
Products	498,993	155,549
Services	22,781	
Total costs of revenue	521,774	155,549
GROSS MARGIN	**185,288**	**42,005**
EXPENSES		
Sales and marketing	698,185	356,948
General and administrative	2,092,775	953,484
Depreciation and Amortization	40,627	224,770
Impairment of asset		893,667
TOTAL OPERATING EXPENSES	**2,831,587**	**2,428,869**
OPERATING LOSS	**-2,646,299**	**-2,386,864**
Other Income (Expense)		
Change in fair value of equity investments	429,755	
Dividend received from equity investment	186,397	
Interest Expense	-648,875	
Total other (expense), net	-32,723	
NET LOSS	**-2,679,022**	**-2,386,864**
Less: Net loss (income) attributable to non-controlling interest	49,695	10,763
NET LOSS ATTRIBUTABLE TO APPLIED BIOSCIENCES CORP.	($2,629,327)	($2,376,101)
LOSS PER COMMON SHARE	($0.22)	($0.16)
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic and diluted	11,914,525	15,071,417

Table 3: Evaluation for the Applied BioSciences (APPB) Case

We ask participants to specify their agreement with the following statements, where 1 = "Strongly Agree", 2 = "Agree", 3 = "Neutral", 4 = "Disagree", and 5 = "Strongly Disagree"

Item	**Auditing** Mean (SD)	**Int Acc** Mean (SD)
1. Completing the APPB case helped me understand ethical issues in general.	1.71 (0.62)	NA
2. Completing the APPB case helped me understand how several groups can be affected by unethical acts.	1.62 (0.64)	NA
3. Completing the APPB case helped me understand how goodwill is computed and reported in a real-world setting.	NA	1.90 (0.54)
4. Completing the APPB case helped me understand how to assess and critically evaluate a recent acquisition and related goodwill.	NA	1.90 (0.54)
5. Completing the APPB case helped me understand how to do analytical procedures – horizontal analysis	1.62 (0.82)	1.40 (0.49)
6. Completing the APPB case helped me understand how to do analytical procedures – vertical analysis	1.62 (0.82)	1.80 (0.60)
7. Completing the APPB case helped me understand how fraud triangle can be applied to a MicroCap company.	1.5 (0.72	NA
8. Completing the APPB case helped me understand fraud risk factors (red flags) that are related to management attitudes and rationalizations	1.54 (0.66)	NA
9. Completing the APPB case helped me understand how to navigate the notes to the financial statements.	NA	1.70 (0.90)
10. Completing the APPB case helped me understand how the notes to the financial statements can be used to evaluate management's assertions in the balance sheet and the income statement.	NA	1.60 (0.66)
11. The level of difficulty in this case was appropriate for an upper-level accounting course.	1.66 (0.87)	NA
12. The level of difficulty in this case was appropriate for an intermediate level accounting course.	NA	2.00 (0.89)
13. Analyzing this case as a group project was beneficial.	1.58 (0.77)	2.30 (0.78)
14. Overall, this case was a useful learning tool.	1.50 (0.66)	1.70 (0.64)

Table 4. Student Feedback

Listed below is a sample of student comments about the case:

Auditing Students	Intermediate Accounting Students
"I had fun and learned a lot."	*"I think the use of the real-world situations is a great way to get students who are going into accounting as their major to fully understand what it is that they are learning and why it is critical to understand it."*
"The case was a very helpful learning tool that helped apply material from class to real-world situations."	*"I think it was interesting and beneficial for the most part."*
"Let us pick our own groups, if possible."	*"It was a bit hard to follow overall in my opinion. I did the best I could for the time I had available."*
"It is a good group project; some parts could have been independent assignments."	*"Good project for navigating and evaluating financial notes in conjunction with performing the financial analysis."*
"Overall, I liked the case studies and they helped me apply the material we were learning in class."	