



THE CATHOLIC UNIVERSITY OF EASTERN AFRICA

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**SPECIAL/SUPPLEMENTARY EXAMINATION**

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**MAY- AUGUST 2021**

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**SCHOOL OF BUSINESS**

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**DEPARTMENT OF ACCOUNTING AND FINANCE**

**CAC 422: EMERGING AND CONTEMPORARY ISSUES IN ACCOUNTING**

**Date: AUGUST 2021**

**Duration: 2 Hours**

**INSTRUCTIONS: Answer Question ONE and any other TWO Questions**

**Question 1 (30 marks)**

- Explain briefly in what ways financial reporting irregularities have contributed to the collapse of financial markets (2 marks)
- Internal control weaknesses can adversely affect the quality of financial reporting. Indicate three firm characteristics that are likely to contribute to weak internal controls. In each case justify your answer. (6 marks)
- Explain what is meant by the following concepts in the context of the agency relationship; (i) moral hazard, and (ii) information asymmetry. (4 marks)
- The details of the directors and some financial figures of two companies listed in the Nairobi Securities Exchange for the same year are given in Table 1 below:

**PANEL A: Total Kenya Limited**

Name of director	Age of director	Position(s)
Jean Papee	54	Chair of the board
Patrick Waechter	46	Director and Finance Director
Alexis Vovk	47	Director and Managing Director
Maurice K'Anjejo	54	Director and Corporate Affairs Manager
Daniel Mayieka	41	Director and Specialties Manager

Alain Champeaux	62	Director
Alice Mayaka	60	Director
Sophie Nassir	39	Director
Net income before extra-ordinary items (sh)		(71,436,000)
Net cashflow from operating activities (sh)		(2,005,741)

**PANEL B: Kengen Limited**

Name of director	Age of director	Position(s)
Hon. Titus Mbathi	82	Chair of the board
Edward Njoroge	58	Director and CEO
Dorcas Kombo	57	Director
Henry M'Narobi	65	Director
Mary Michieka	64	Director
Jeremiah Ndeto	59	Director
George Njagi	64	Director
Patrick Nyoike	63	Director
Joseph Kinyua	64	Director
Hedrick Omanwa	46	Director
Sarah Wainaina	69	Director
Net income before extra-ordinary items (sh)		4,512,526
Net cashflow from operating activities (sh)		2,080,121

**Required:**

- i. Based on the information given above, assess which of the two companies best complied with the CMA Act 2015. Justify your answer. (4 marks)
  - ii. Which of the two companies would you expect to have higher quality financial reporting? Provide support for your answer. (2 marks)
  - iii. Assess whether your prediction is supported by the quality of earnings ratio. (3 marks)
1. (a) Explain what is meant by fraud alerts and give three examples (4 marks)
  - (b) Read the following scenario and answer the question that follows:

*Marcos Mayaka was the desk manager, who had been fired by a previous employer, and Betty Kitoto was the head of housekeeping at the Excelsior Inn, a luxury hotel. The two best friends were so dedicated to their jobs that they never took vacations, and they frequently filled in for other employees. In fact, Ms. Kitoto whose job as head of housekeeping did not include cleaning rooms, often cleaned rooms herself, "just to help the staff keep up." Marcos, the desk manager, provided significant discounts to guests who paid with cash. He kept the cash and did not register the guest in the hotel's computerized system. Instead, he took the room out of circulation "due to routine maintenance." Because the room did not show up as being used, it did not receive a normal housekeeping assignment. Instead, Betty, the head of housekeeping, cleaned the rooms during the guests' stay. The two best friends perpetrated fraud amounting to Sh 950,000 before they were eventually discovered when Mr. Mayaka missed work for several days due to illness.*

**Required:**

Explain the missing control(s) in this scenario that Mr. Mayaka and Ms. Maundu took advantage of. (2 marks)

2. Explain why executive compensation has been such a contentious issue in financial reporting. (4 marks)
3. Explain what is meant by integrated reporting. (2 marks)
4. DataSpan Company Limited, automated its plant at the start of the current year and installed a flexible manufacturing system. The company is also evaluating its suppliers and moving toward a just-in-time (JIT) inventory system. Many adjustment problems have been encountered, among them problems relating to performance measurement. After much study, the company has decided to use the performance measures below as part of its balanced scorecard, and it has gathered data relating to these measures for the first four months of operations.

Month

	1	2	3	4
Throughput time (days)	?	?	?	?
Delivery cycle time (days)	?	?	?	?
Manufacturing cycle efficiency (MCE)	?	?	?	?
Percentage of on-time deliveries	91%	86%	83%	79%
Total throughput (units)	3,210	3,072	2,915	2,806

Management has asked for your help in computing throughput time, delivery cycle time, and MCE. The following average times have been logged over the last four months:

	Average per month (in days)			
	1	2	3	4
Move time per unit	0.4	0.3	0.4	0.4
Process time per unit	2.1	2.0	1.9	1.8
Wait time per order	16.0	17.5	19.0	20.5
Queue time per unit	4.3	5.0	5.8	6.7
Inspection time per unit	0.6	0.7	0.7	0.6

**Required:**

- i. For each month, compute the following operating performance measures:
  - a. The throughput time, or velocity of production. (2 mark)
  - b. The MCE. (2 marks)
- ii. Evaluate the company's performance over the last four months in terms of value-added activities. (3 marks)

**Section B. (choose TWO questions from this section)**

5. (a) Distinguish between auditors' "independence in fact" and "independence in appearance" (2 marks)
- (b) Explain five factors that may improve the audit quality (5 marks)

(c) Use the data provided in Table 2 below to answer the questions that follow:

**Table 2: Data for the auditor Aidman Piser & Company for the year 2006**

#	Client name	SIC code	Audit fees (\$)	Non-audit fees (\$)	Total fees (\$)
1	Biovest international inc.	28	161,000	-	161,000
2	Calton inc.	15	78,100	3,657	81,757
3	Star scientific inc.	28	415,500	61,351	476,851
4	Powerlinx inc	36	96,470	30,750	127,220
5	Nanobac pharmaceuticals inc.	28	114,000	-	114,000
6	Azzurra holding corp.	36	146,000	-	146,000
7	Earthfirst technologies inc.	39	160,600	102,300	262,900
8	Biodelivery sciences Intl. inc.	28	100,400	23,566	123,966
9	Invisa inc.	38	69,400	49,000	118,400
10	Accentia Biopharmaceuticals	28	283,887	236,657	520,544
11	Amstem Corp.	80	31,500	-	31,500

- (i) Assuming that the clients appearing in Table 2 were the only clients for auditor Aidman Piser & Company during the year 2006, determine whether the auditor Aidman Piser & Company may be considered as an industrial specialist for year 2006 and for which industry (in terms of the SIC code). Show all the necessary workings. (4 marks)
- (ii) Assess the audit quality of the auditor Aidman Piser & Company during the year 2006 based on the following measures:
- Auditor size (2 marks)
  - Provision of non-audit services (3 marks)

- (iii) The following additional information is available for the client number 10 in Table 2, Accentia biopharmaceuticals Inc.

Year	Audit fees (USD)	Non-audit fees (USD)	Total fees (USD)
2007	571,000	101,500	672,500
2006	283,887	236,657	520,544
2005	371,000	163,000	534,000
2004	295,000	91,000	386,000

**Required:**

Comment on the audit quality provided to the client Accentia biopharmaceuticals Inc. on the basis of (1) auditor tenure, (2) low-balling (assume that 2004 was the year of first engagement for the auditor Aidman Piser & Company). (4 marks)

6. (a) Explain what is meant by earnings management (2 marks)  
(b) Identify two specific within-GAAP strategies or mechanisms by which company management may engage in earnings management (2 marks)  
(c) List four consequences of earnings management (4 marks)  
(d) use the data provided in Table 3 to answer the questions that follow:

**Table 3: Abnormal cash flows, production costs, discretionary expenses and discretionary accruals**

Company	Year	ACF	APR	ADI	AD	Company	Year	ACF	APR	ADI	AD
		O	OD	SX	A			O	OD	SX	A
	201			-	0.0		201			-	2.0
1	1	0.05	0.11	0.01	0	4	0	0.44	0.03	1.15	5
					-						-
	201				0.0		201			-	0.1
1	2	0.00	0.08	0.22	1	4	1	0.42	-0.01	0.85	1
					-					-	1.7
1	3	0.03	0.14	0.12	1	4	2	1.02	0.09	2.01	1
					-						-
	201				0.9		201			-	2.0
2	0	0.01	0.17	0.46	5	4	3	1.49	0.04	6.73	1
					-						-
	201	-		-	0.0		201			-	0.0
2	1	0.09	0.18	0.15	8	5	0	0.14	-0.11	0.09	1
					-						-
	201	-		-	0.6		201			-	0.1
2	2	0.06	0.10	0.01	1	5	1	0.15	-0.15	0.14	1
					-						-
	201	-		-	0.0		201	-		-	0.3
2	3	0.09	0.24	0.04	5	5	2	0.03	-0.13	0.17	0
					-						-
	201			-	0.0		201			-	1.4
3	0	0.20	0.06	0.41	1	5	3	0.89	0.80	0.16	8
					-						-
	201			-	0.9						-
3	1	0.06	0.05	0.35	0						-
					-						-
	201			-	0.0						-
3	2	0.33	0.02	0.37	3						-
					-						-
	201			-	0.0						-
3	3	0.24	0.01	0.33	4						-

Key to Table 3:

Company	Company name	Variabl	Description
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1	AAR Corp	ACFO	Abnormal cash flows from operations
2	Cheniere Energy Inc	APROD	Abnormal production costs
3	American Science Engineering	ADISX	Abnormal discretionary expenses
4	American Vanguard Corp	ADA	Abnormal discretionary accruals
5	Apache Corp		

- (i) Company management may engage in earnings management by using either real activities or accruals earnings management. Match the four variables in Table 3 (ACFO, APROD, ADISX, and ADA) to either of the two methods of earnings management. (2 marks)
- (ii) If a company has engaged in earnings management what sign would you expect the variables ACFO, APROD, and ADISX to take? (3 marks)
- (iii) Using the ADISX and ACFO variables together, and ignoring APROD and ADA, assess any of the five companies whose data appears in Table 3 may have engaged in earnings management on any of the years between 2010 and 2013. Justify your assessment. (7 marks)
7. Read the case below and answer the questions that follow;



## Key Players

Lisa Gipson is 24 years old and has worked as an Internal Auditor I for New Beginnings for 2.5 years. Prior to accepting her current position, she graduated with her B.S. in accounting. Upon graduating, she didn't expect to land an auditing position. She stated, "I never ever thought I would have been an auditor." Of the several jobs she applied for, she only received offers for internal audit positions. She is also currently working on a MBA and plans to sit for the CPA exam. And, after acquiring two years experience and achieving a top score on an exam for promotion, she is now eligible for promotion to Internal Auditor II.

Carl Campbell is the agency's CFO and has occupied the position for 14 years. After 35 years with New Beginnings, he's scheduled to retire within the year. To his Accounting & Finance Division employees, he is known for getting what he wants no matter what. To gain and retain his favor, one must do things the way he likes. Although he has established layers of accounting supervisors and managers within the division, he is known as a micromanager. He's the agency's accounting, finance, and budget expert, and he wields a tremendous amount of power and influence. And, at times, that influence is known for overreaching the boundaries of his division into others, even in regards to hiring, promotion, and firing.

## The Agency

New Beginnings is a non-profit agency that serves the various needs of ex-convicts in an effort to reduce recidivism rates. It provides them with the resources necessary to return to society as productive citizens. Some of the services include specialized employment-related, education-related, and social-related services such as assisting with job placement, regaining voting rights, GED preparation, and life skills development. The agency uses seven regional offices strategically dispersed throughout the state to provide the services to eligible residents. The agency oftentimes subcontracts with other organizations to provide such services. It employs more than 250 employees, and its central office is located in the capital city. Lisa states that the culture of the agency at the central office is "very laxed, very reactive," and one in which "management's perception of the audit function" is one which "nobody really understands what we're supposed to be doing," including key personnel such as the Executive Director and CFO.

In 2011, the agency operated on approximately \$28 million comprised mostly of federal sources of revenue in the form of grants. Those grants accounted for more than 75% of the agency's total revenue. And, of that federal source of revenue, \$7 million was awarded as part of the American Recovery and Reinvestment Act of 2009 (ARRA), also known as the federal stimulus package.

## The Audit

Lisa Gipson and her supervisor, Eric Simpson, were charged with the responsibility of assessing internal controls over the central office's contract payments process involving 10 two-year contracts. They were to review and examine the records of payments tied to those contracts for compliance to stipulated grant award rules and guidelines. Those 10 contracts were of importance because they involved the expenditure of more than \$2 million in ARRA funds for

services provided by subcontractors of New Beginnings. Oversight over the contract payments was a function of the Grants & Contracts Section which fell under the Accounting & Finance Division.

After obtaining an understanding of the task at hand, Lisa and Eric worked to plan and coordinate the audit. They agreed to distribute the work by contracts and to audit the total population of contract payments. Of the 10 contracts, Lisa was to audit seven and Eric three. Lisa's preliminary steps for her portion of the audit began with familiarizing herself with the grant award rules and guidelines that governed how the ARRA funds were to be accounted for and used. She decided she would refer back to the grant award rules and guidelines as needed throughout the audit. After several hours of reviewing the material, she proceeded on to the next step, locating and examining contract payments.

With a payment vouchers report generated from the agency's accounting system, Lisa identified the contract payments tied to the contracts she was responsible for examining. She identified 16 (4 quarterly and 12 monthly) vouchers that were used to issue those payments to reimburse the agency's subcontractors. She then went to the Accounting & Finance Division file room, located and retrieved the vouchers in question. Upon returning to her office with the vouchers and beginning a thorough examination of them, she was alarmed by her discovery.

As Lisa examined the payment vouchers along with their supporting documentation, she noticed some payments being approved and made without sufficient documentation. The key piece of supporting documentation missing from those payments was invoices for goods or services. Paid invoices were mandatory as documentation, however, only purchase orders were included by the subcontractors. Lisa was puzzled how such payments could be made and troubled by the fact that the total amount of payments in question was approximately \$1 million. Sam Watson was the accountant responsible for issuing payments to satisfy the reimbursement requests, and part of Lisa's examination involved retracing Sam's steps. She stated, "I was doing the same thing that the accountant that issued the payments was doing. I reviewed the same documentation. We had people making payments for items of \$20,000. We issued payments for trucks, vans. I mean we're talking about very expensive equipment that's not supported by an invoice. It's supported by a purchase order." Lisa reassured herself that she properly conducted her portion of the audit by referring back to the grant award rules and guidelines. She then brought the matter to Eric's attention. She also followed-up with Sam. And, the information he shared with her only alarmed her more.

With some paid reimbursement requests in hand and a copy of the grant award guidelines, Lisa paid a visit to Sam. She inquired of him how he arrived at the conclusion that the payments made were appropriate. Lisa only assumed Sam thought they were appropriate because they left his desk to be approved for payment. She stated that Sam said he determined the requests for payment to be inadequate due to insufficient supporting documentation. He went on to tell her that he sought the advice of his supervisor, who subsequently brought it to the attention of the CFO, Carl Campbell. To Lisa's dismay, Sam produced an e-mail that he received from Mr. Campbell regarding the matter. The e-mail instructed Sam how to handle the reimbursement requests, and part of the instructions was "Just pay it!" Knowledge of Lisa's dialogue with Sam regarding the matter was immediately made known to Mr. Campbell. Lisa stated, "Then he sent out an e-mail instructing the Accounting & Finance Division to limit what information that they provide to us."

responsible for preparing and submitting the report. Lisa stated, “My supervisor didn’t see a lot. He really didn’t have findings.” Lisa informed Eric of her findings and the audit issues encountered. Then, she prepared a formal list of her findings and gave it to Eric. Lisa presented eight findings, findings which he approved for inclusion in the audit report which only reported Lisa’s findings. She and Eric later met with the Deputy Director, who is the agency head under which the Office of Internal Audit fell, to discuss the audit and the audit report. After the meeting, the preliminary audit report was forwarded to Mr. Campbell by e-mail for his review as a standard preliminary step before arranging the audit exit conference and issuance of the final audit report.

A few days after the receipt of the audit report by the Mr. Campbell, he arranged a meeting between himself, his Grants & Contracts Section, and the Office of Internal Audit to discuss the report. Upon being informed of the meeting by the Deputy Director, Lisa assumed it would be an opportunity to set in place corrective actions to resolve the audit deficiencies before the issuance of the final audit report. However, what she experienced during the meeting left her very disturbed.

### **The Meeting**

The meeting was held in the Executive Director’s conference room. Those in attendance were Lisa, Eric, Sam Watson’s supervisor, Mr. Campbell, the Executive Director, and Deputy Director. The Executive Director convened the meeting and yielded the floor to the Office of Internal Audit. Eric began to enumerate and expound on the findings. Lisa stated that as Eric proceeded, Mr. Campbell fiercely questioned the judgment and objectivity that led to the findings, which thrust Lisa into the discussion. Regarding her findings, Lisa stated “They weren’t received very well at all!”

Lisa interjected into the discussion how she arrived at the findings. She informed those in attendance that based on her understanding and interpretation of the guidelines pertaining to the use of the ARRA funds in question, her findings were warranted. She also stated that the paid reimbursement requests that lacked paid invoices simply violated internal controls. Lisa emphasized that the approximately \$1 million in total deficiencies could have significant consequences if not resolved. Despite her continued attempt to justify her position, Mr. Campbell was not satisfied and questioned the due care she exercised. She said she found herself quite uncomfortable being accused of such a thing by Mr. Campbell, a career employee with the agency with 35 years of experience and tremendous influence. Lisa stated she inwardly assured herself that she did a thorough job but was concerned about the weight of her justification for her findings against the accusations of the seasoned Mr. Campbell. After occasional flares of Mr. Campbell’s temper and much back-and-forth between him and Lisa, Lisa stated that he abruptly concluded the findings weren’t justified and demanded they be removed from the report. After which, a silence fell over the conference room, and the meeting was adjourned shortly thereafter.

Upon immediately returning to her office, Lisa digested what had just taken place during the meeting. She carefully weighed her options regarding the matter and pondered on possible actions she should take. And, with time ticking away, she knew she had to act soon.

**Required:**

Answer the following questions and in each case refer to the page and paragraph where you find support for your answer if required.

- a. Identify the two main characters in this case? (2 marks)
- b. What problem is Lisa having to grapple with? (1 mark)
- c. With reference to the fundamental principles of the code of ethics for professional accountants, and with reference to the case, evaluate Lisa's behaviour as a professional accountant. Which fundamental principles would you say has much to do with the problem Lisa is facing? Describe that (those) principle(s) and clearly explain why you think it best fits this case. (4 marks)
- d. Suggest three options that Lisa can take to deal with the issue she is facing. (3 marks)
- e. You have been independently asked by the grant providers to investigate any evidence of fraud at Best Beginnings. From the case, identify any fraud alerts or warning signs that would suggest fraudulent activity in Best Beginnings. (5 marks)
- f. Suggest a strategy on how to deal with the issue Lisa has discovered at New Beginnings. (5 marks)