

Pinnacle manufacturing case

[Business](#), [Industries](#)



Original Work please INTEGRATED CASE APPLICATION -PINNACLE

MANUFACTURING: PART II 9-37 (Objectives 9-7, 9-8) In Part I of the case, you performed preliminary analytical procedures for Pinnacle (pp. 245-247). The purpose of Part II is to identify factors influencing risks and the relationship of risks to audit evidence. During the planning phase of the audit, you met with Pinnacle's management team and performed other planning activities. You encounter the following situations that you believe may be relevant to the audit: 1.

Your firm has an employee who reads and saves articles about issues that may affect key clients. You read an article in the file titled, " EPA Regulations Encouraging Solar-Powered Engines Postponed? " After reading the article, you realize that the regulations management is relying upon to increase sales of this division might not go into effect for at least ten years. A second article is titled, " Stick to Diesel Pinnacle! " The article claims that although Pinnacle has proven itself within the diesel engine industry, they lack the knowledge and people necessary to perform well in the solar-powered engine industry. . You ask management for a tour of the Solar-Electro facilities. While touring the warehouse, you notice a section of solar-powered engines that do not look like the ones advertised on Pinnacle's Web site. You ask the warehouse manager when those items were first manufactured. He responds by telling you, " I'm not sure. I've been here a year and they were here when I first arrived" 3. You also observe that new computerized manufacturing equipment has been installed at Solar-Electro. The machines have been stamped with the words, " Product of Welburn Manufacturing, Detroit, Michigan. 4. During a meeting with the facilities director, you learn

that the board of directors has decided to raise a significant amount of debt to finance the construction of a new manufacturing plant for the Solar-Electro division. The company also plans to make a considerable investment in modifications to the property on which the plant will be built. 5. While standing in line at a vending machine, you see a Pinnacle vice president wearing a golf shirt with the words "Todd-Machinery" You are familiar with the company and noticed some of its repairmen working in the plant earlier.

You tell the man you like the shirt and he responds by saying, " Thank you. My wife and I own the company, but we hire people to manage it. " 6. After inquiry of the internal audit team, you realize there is significant turnover in the internal audit department. You conclude the turnover is only present at the higher-level positions. 7. While reviewing Pinnacle's long-term debt agreements, you identify several restrictive covenants. Two requirements are to keep the current ratio above 2. 0 and debt-to-equity below 1. 0 at all times. 8.

While reading the footnotes of the previous year's financial statements, you note that one customer, Auto-Electro, accounts for nearly 15% of the company's accounts receivable balance. You investigate this receivable and learn it has been outstanding for several months. 9. The engagement partner from your CPA firm called today notifying you that Brian Sioux, an industry specialist and senior tax manager from the firm's Ontario office, will be coming on-site to Pinnacle's facilities to investigate an ongoing dispute between the Internal Revenue Service and Pinnacle. 0. A member of your CPA firm, who is currently on-site in Detroit at the Welburn division, calls you to see how everything is going while you are visiting Solar-Electro in Texas.

During your conversation, he asks if you know anything about the recent intercompany loan from Welburn to Solar-Electro. 11. During discussions with the Pinnacle controller, you learn that Pinnacle employees did a significant amount of the construction work for a building addition.

The controller stated that the work was carefully coordinated with the construction company responsible for the addition. Required a. Identify specific considerations from Parts I and II of the case that affect your assessments of engagement risk and acceptable audit risk. Use each of the three factors in the text to categorize your conclusions: External users' reliance on financial statements Likelihood of financial difficulties Management integrity As the Independent Auditor I would require from Pinnacle, the client a Management Representation Letter.

This is a letter an auditor is required to obtain from management at the conclusion of fieldwork, confirming representations explicitly or implicitly given to the auditor, indicating and documenting the continuing appropriateness of such representations, and reducing the possibility of misunderstanding regarding the representations. b. Assess acceptable audit risk as high, medium, or low considering the items you identified in requirement a. (A risky client will be assessed as a low acceptable audit risk. I will identify the audit risk as high. c. Identify inherent risks for the audit of Pinnacle using the information from Parts I and II. For each inherent risk, identify the account or accounts that may be affected. (1) Related Parties - A reporting entity's affiliates, principal owners, and management also, any members of their immediate families. Points of consideration is a Pinnacle VP owning Todd-Machinery, its repair men working at Pinnacle at the time the

auditor was at field work, while standing in front of vending machine. 2) While reviewing Pinnacle's long-term debt agreements, there were several restrictive covenants. Two requirements are to keep the current ratio above 2.0 and debt-to-equity below 1.0 at all times. This is an item of consideration of possibilities for Pinnacle to "cook the books" so as to keep in compliance with covenant. (3) There is a high turnover of employees. After inquiry of the internal audit team, you realize there is significant turnover in the internal audit department. You conclude the turnover is only present at the higher-level positions. 4) While reading the footnotes of the previous year's financial statements, you note that one customer, Auto-Electro, accounts for nearly 15% of the company's accounts receivable balance. This receivable and learn it has been outstanding for several months. This is an inherent risk of being a related party transaction wherein goods could be sold to Auto-Electro, a related party, but Pinnacle has not received collection of receivables because this is just to make the financial statements look good as having the sale.

Revenue and Inventory accounts are affected. (5) There is an ongoing dispute between Pinnacle and Internal Revenue Service. 10-43 (Objective 10-5) In Parts I and II of this case, you performed preliminary analytical procedures and assessed acceptable audit risk and inherent risk for Pinnacle Manufacturing. Your team has been assigned the responsibility of auditing the acquisition and payment cycle and one related balance sheet account, accounts payable.

The general approach to be taken will be to reduce assessed control risk to a low level, if possible, for the two main types of transactions affecting

accounts payable: acquisitions and cash disbursements. The following are furnished as background information: A summary of key information from the audit of the acquisition and payment cycle and accounts payable in the prior year, which was extracted from the previous audit firm's audit files (Figure 10-12) A flowchart description of the accounting system and internal controls for the acquisition and payment cycle (Figure 10-13, p. 34)—the flowchart shows that although each of the company's three divisions has its own receiving department, the purchasing and accounts payable functions are centralized The purpose of Part III is to obtain an understanding of internal control and assess control risk for Pinnacle Manufacturing's acquisition and cash disbursement transactions. Required a. Familiarize yourself with the internal control system for acquisitions and cash disbursements by studying the information in Figure 10-12 and Figure 10-13. FIGURE 10-12 Information for Audit of Accounts Payable — Previous Year . Prepare a control risk matrix for acquisitions and a separate one for cash disbursements using Figure 10-5 on page 308 as a guide. A formatted control risk matrix is provided on the textbook Web site. The objectives should be specific transaction-related audit objectives for acquisitions for the first matrix and cash disbursements for the second matrix. See pages 608–612 in Chapter 18 for transaction-related audit objectives for acquisitions and cash disbursements. In doing Part III, the following steps are recommended: (1) Controls a.

Identify key controls for acquisitions and for cash disbursements. After you decide on the key controls, include each control in one of the two matrices. b. Include a “ C,” in the matrix in each column for the objective(s) to which

each control applies. Several of the controls should satisfy multiple objectives. (2) Deficiencies a. Identify key deficiencies for acquisitions and for cash disbursements. After you decide on the deficiencies, include each significant deficiency or material weakness in the bottom portion of one of the two matrices. Answer:

During a meeting with the facilities director, you learn that the board of directors has decided to raise a significant amount of debt to finance the construction of a new manufacturing plant for the Solar-Electro division. The company also plans to make a considerable investment in modifications to the property on which the plant will be built. Auditing Presentation and Disclosure. a. Completeness The auditor should ensure that all required disclosures related to accounts payable and purchases have been included in the notes to the financial statements. Required disclosures include: 1.

Payables by type (trade, officer/ employee, affiliates) and term (short-term and long-term) 2. Purchase contracts and purchase commitments. 3. Related party purchases and payables 4. Expenses by segment b. Valuation, Allocation and Accuracy The auditor should read the footnotes and other information related to accounts payable and purchases to determine whether the information is accurate and presented at the appropriate amounts. c. Rights and Obligations and Occurrence The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to accounts payable and purchases has occurred. . Understandability and Classification The auditor should read all accounts payable and purchase related disclosures to ensure that they are understandable. The auditor should determine whether material long-term

payables or non-trade payables require separate disclosure. b. Include a “D,” in the matrix in each column for the objective(s) to which each significant deficiency or material weakness applies. (3) Assess control risk as high, medium, or low for each objective using your best judgment. Do this for both the acquisitions and cash disbursements matrices.

Control risk is to be assessed as high therefore as auditor, I would increase my risk sampling. Expenditure Cycle A. Internal Control- Purchases The following functions in a purchase transaction should be segregated: 1. Purchase Requisition The purchase requisition starts the purchasing cycle. The department in need of the asset or services sends a properly approved, serially numbered requisition to the purchasing department. The requisitioning department should not have the authority to actually place the purchase order. This would indicate a weakness in internal control. 2. Purchase Orders

The purchasing department should place the order only after giving proper consideration to the time to order and the quantity to order. The purchasing department should also obtain competitive bids from various suppliers to make sure that the best price is obtained. The purchase order is issued only after proper approval. For internal control purposes, it is best that pre-numbered purchase orders can be used. There should be multiple copies that will be sent to: (i) the requisitioning department; (ii) the vendor; (iii) the receiving department; and (iv) the accounting department.

If the purchase order is canceled, all copies should be recalled and filed so that every purchase order number is accounted for. 3. Receipt of Goods or Services The copy of the purchase order sent to the receiving department

serves as an authorization to accept the goods when they arrive. It is preferable that the copy not indicate the quantity ordered. Thus, the receiving department is forced to count the goods upon arrival. A receiving report is prepared by this department and forwarded to the accounting department. The goods are forwarded to the requisitioning department .

B. Internal Control - Accounts Payable The accounting department has three functions: (i) to record the payable, (ii) to approve the invoice for payment; and (iii) to record the payment after it is paid by the Treasurer. 1. Recording the Payable The copy of the purchase order sent to the accounting department notifies them that there will be a future cash disbursement. The receiving report is compared with the purchase order and the vendor's invoice as to the quantity to prevent payment of charges for goods in excess of those ordered and received.

The accounting department records the goods as received in inventory, and records a payable. 2. Approving Invoice for Payment and Recording Payment When the invoice arrives, the accounting department approves it by matching the invoice, purchase order, receiving report, and (sometimes) the requisition. When payment is made, the payable is reversed. The accounting department should ensure that the invoice amount is correct, and that it accurately reflects any purchase discounts, before approving it for payment.

C. Internal Control - Cash Disbursements

It is best for internal control purposes to pay invoices by check. For effective internal control, the functions of approving the payment and signing the checks should be segregated. Approved voucher packets (matched invoice, purchase order, receiving report, and requisition) prepared by the

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accounting department (Accounts Payable) are received by the Treasurer, who prepares, signs, and mails the checks and cancels all supporting documents after payment. Paid vouchers are returned to the accounting department for posting of the payment and filing of the documents.