Dynamic Seating Systems, Inc.: An Analytical Procedures Case

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ABSTRACT: *In this fictitious accounting case, students act as senior external auditors performing planning stage analytical procedures. Company background, current and prior year financial statements and ratio analysis are provided.*

INTRODUCTION

You are a senior auditor for Baker and Todd, LLP, Certified Public Accountants, which is a regional accounting firm with about 500 professional staff in four offices in the southeast. Baker and Todd was formed twenty-six years ago and offers a range of auditing, tax and consulting services. The firm is registered with the Public Company Accounting Oversight Board (PCAOB) and is thus eligible to perform the audits of public companies. Baker and Todd has accepted a new audit client, Dynamic Seating Systems, Inc. (DSS). DSS is a regional manufacturer of interlocking seating systems which sells and installs seats for various auditoriums (schools, churches, concert halls, etc.). A smaller and newer business segment targets movie theaters. This segment only accounts for 15% of sales, but it carries a higher profit margin than other product lines due to patent-pending rocking and reclining mechanisms that have been favored by key theater chains. Due to this higher margin, management began an aggressive growth plan for the movie theater segment in the current year.

DSS has been incorporated fourteen years and is headquartered in Nashville, Tennessee. DSS sells mostly on credit to customers in the southeast region of the United States, but the company has been expanding considerably into the northeast in recent years. In general, DSS is known for the high quality of its products and has therefore been able to mark up its product higher than most of its competitors for many years. Furthermore, higher quality has allowed DSS to somewhat avoid the pressure on profit margins experienced by some competitors in recent years due to price competition. Higher priced products have caused some challenges in the schools market segment, however, due to the bidding process for government contracts. In response, the company has developed a small line of lower budget products which it markets to public school systems.

The production process for seating systems is capital intensive, requiring investments in factories and machinery to convert raw materials to finished products. Also, the current trend is toward customers demanding a greater variety of product colors and styles meaning smaller, more numerous production runs which increase set-up time and decrease efficiency. Numerous suppliers for raw materials causes competitive pricing which tends to control raw material costs. As to labor costs, labor content generally bears a direct relationship with the quality of seating products being produced.

The seating system industry is highly competitive. Growth in the industry has been about 8% in 20X7 and 20X8. That growth slowed to 7% in the current year primarily due to a slowdown in seating replacement sales as increasing interest rates caused some companies to delay improvements. This slowdown was partially offset by an increase in theater seating sales as the movie theater industry expanded due to a stronger overall economy and increases in discretionary spending. Growth in the seating system industry overall is expected to continue but at a declining rate over the next few years.

Patrick Stone has served as Chief Executive Officer of the company since its inception. The rest of the senior management team is comprised of COO Derrick Williams who has seven years with the company and eleven years of prior experience in the industry and CFO Collette Spencer who has three years with DSS and nine years of previous public accounting experience. DSS maintains a seven-member board of directors with Mr. Stone serving as chairman of the board. The board also includes Mr. Williams and the company's chief attorney. The remaining board members are men and women with extensive business experience (an average of 16 years) who have no other relation to the company. The company also maintains an audit committee comprised of independent directors including one certified public accountant.

DSS is privately held but has a small amount of public debt and plans an initial public offering of its common stock within the next 24 months. The company has been audited by a mid-sized local firm for the previous 7 years to satisfy terms of its debt agreement. DSS experienced some audit adjustments in the previous year but had no significant disagreements with the previous auditor. The change to a larger, PCAOB-registered firm was made to facilitate the transition to being a public company.

REQUIREMENTS

As a senior auditor on this engagement, you have been asked to perform initial analytical procedures for audit planning purposes. Identify areas of risk the firm should keep in mind for the upcoming audit including the risk of material misstatement and business risks the company may face. For each item you note, be sure to state the significant difference or inconsistency you see in the numbers that lead you to believe a risk exists and state the related implications for the audit and for the company (e.g., what account(s) may be misstated and in which direction). Your explanation of implications should include your hypotheses for why the observed inconsistency exists.

	Dynamic Seating Systems, Inc. Ratio Analysis December 31 **Prepared by Client**		
	20X9	20X8	Industry Average
Cash ratio	0.303	0.351	0.327
Quick ratio	1.058	1.061	1.067
Current ratio	1.539	1.529	1.545
Accounts receivable turnover	5.012	5.131	5.376
Days to collect accounts receivable	72.822	71.136	67.899
Inventory turnover	6.476	7.010	6.745
Days to sell inventory	56.363	52.068	54.115
Debt to equity	1.628	1.675	0.998
Times interest earned	3.993	4.063	4.389
Gross profit percentage	0.277	0.270	0.236
Profit margin	0.079	0.085	0.080
Return on assets	0.084	0.088	0.086
Return on common equity	0.223	0.245	0.172
Earnings per share	$1.55	$1.63	$1.21

Prepared by Client

Dynamic Seating Systems, Inc.
Balance Sheet
December 31

	20X9 Unaudited	20X8 Audited	$ Change	% Change
Assets				
Cash and Cash Equivalents	$ 2,511,540	$ 2,712,290	$ (200,750)	-7.40%
Accounts Receivable (net of allowance for doubtful accounts of $154,232 and $146,555 respectively)	$ 6,243,369	$ 5,485,987	$ 757,382	13.81%
Inventory	$ 3,457,626	$ 3,103,698	$ 353,928	11.40%
Prepaid Expenses	$ 527,500	$ 520,500	$ 7,000	1.34%
Total Current Assets	$ 12,740,035	$ 11,822,475	$ 917,560	7.76%
Property, Plant & Equipment	$ 19,148,150	$ 17,298,200	$ 1,849,950	10.69%
Accumulated Depreciation	$ (10,400,480)	$ (9,650,230)	$ (750,250)	7.77%
Property, Plant & Equipment, net	$ 8,747,670	$ 7,647,970	$ 1,099,700	14.38%
Other Assets	$ 382,947	$ 307,039	$ 75,908	24.72%
Total Assets	21,870,652	19,777,484	$ 2,093,168	10.58%
Liabilities and Shareholders' Equity				
Accounts Payable	$ 1,264,152	$ 994,152	$ 270,000	27.16%
Accrued Compensation Expense	$ 763,900	$ 793,789	$ (29,889)	-3.77%
Customer Deposits	$ 1,320,038	$ 1,408,026	$ (87,988)	-6.25%
Notes Payable	$ 1,065,816	$ 975,816	$ 90,000	9.22%
Other Accrued Expenses	$ 3,370,086	$ 3,238,732	$ 131,354	4.06%
Current Portion of Long Term Debt	$ 492,500	$ 320,000	$ 172,500	53.91%
Total Current Liabilities	$ 8,276,492	$ 7,730,515	$ 545,977	7.06%
Long Term Debt	$ 4,917,520	$ 4,310,020	$ 607,500	14.10%
Deferred Income Taxes	$ 353,333	$ 342,897	$ 10,436	3.04%
Total Liabilities	$ 13,547,345	$ 12,383,432	$ 1,163,913	9.40%
Common Stock	$ 650,000	$ 610,400	$ 39,600	6.49%
Additional Paid in Capital	$ 834,100	$ 772,502	$ 61,598	7.97%
Retained Earnings	$ 6,839,207	$ 6,011,150	$ 828,057	13.78%
Total Equity	$ 8,323,307	$ 7,394,052	$ 929,255	12.57%
Total Liabilities and Shareholders' Equity	$ 21,870,652	$ 19,777,484	$ 2,093,168	10.58%

Prepared by Client

Dynamic Seating Systems, Inc.
Statement of Operations
For the Year Ended December 31

	20X9 Unaudited	20X8 Audited	$ Change	% Change
Net Sales	$ 29,395,160	$ 27,500,120	1,895,040	6.89%
Cost of Goods Sold	$ 21,245,250	$ 20,070,230	1,175,020	5.85%
Gross Profit	$ 8,149,910	$ 7,429,890	720,020	9.69%
Depreciation	$ 750,250	$ 650,670	99,580	15.30%
Selling Expenses	$ 2,925,002	$ 2,594,995	330,007	12.72%
General and Administrative Expenses	$ 1,978,001	$ 1,687,995	290,006	17.18%
Other Expenses	$ 172,150	$ 170,023	2,127	1.25%
	$ 5,825,403	$ 5,103,683	721,720	14.14%
Operating Income	$ 2,324,507	$ 2,326,207	(1,700)	-0.07%
Interest Expense	$ 582,120	$ 572,520	9,600	1.68%
Interest Income	$ (30,120)	$ (25,650)	(4,470)	17.43%
Other Expense, net	$ 22,513	$ 19,750	2,763	13.99%
	$ 574,513	$ 566,620	7,893	1.39%
Income Before Taxes	$ 1,749,994	$ 1,759,587	(9,593)	-0.55%
Income Tax Expense	$ 743,937	$ 761,812	(17,875)	-2.35%
Net Income	$ 1,006,057	$ 997,775	8,282	0.83%
Retained Earnings, Beginning of the Year	$ 6,011,150	$ 5,168,375	842,775	16.31%
Dividends	$ (178,000)	$ (155,000)	(23,000)	14.84%
Retained Earnings, End of the Year	$ 6,839,207	$ 6,011,150	828,057	13.78%

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Dynamic Seating Systems, Inc.
Statement of Cash Flows
For the Year Ended December 31

	20X9 Unaudited	20X8 Audited	$ Change	% Change
Cash Flows from Operations				
Net Income	$ 1,006,057	$ 997,775	8,282	0.83%
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation	$ 450,250	$ 400,670	49,580	12.37%
Deferred Income Taxes	$ 10,436	$ (68,102)	78,538	-115.32%
Net Gains/Losses on Disposal of Assets	$ (11,252)	$ (8,676)	(2,576)	29.69%
Changes in current operating assets and liabilities:				
Accounts Receivable	$ (757,382)	$ (180,876)	(576,506)	318.73%
Inventory	$ (353,928)	$ 66,368	(420,296)	-633.28%
Prepaid Expenses	$ (7,000)	$ 33,590	(40,590)	-120.84%
Accounts Payable	$ 270,000	$ (114,824)	384,824	-335.14%
Accrued Compensation Expense	$ (29,889)	$ (37,434)	7,545	-20.16%
Customer Deposits	$ (87,988)	$ (109,634)	21,646	-19.74%
Notes Payable	$ 90,000	$ 10,373	79,627	767.64%
Other Accrued Expenses	$ 131,354	$ (507,990)	639,344	-125.86%
Net Cash Provided by (Used In) Operating Activities	$ 710,658	$ 481,240	229,418	47.67%
Cash Flows from Investing Activities				
Purchases of Property, Plant and Equipment	$ (1,607,078)	$ (736,305)	(870,773)	118.26%
Proceeds from the Sale of Property, Plant and Equipment	$ 292,472	$ 190,066	102,406	53.88%
Net Cash Provided by (Used In) Investing Activities	$ (1,314,606)	$ (546,239)	(768,367)	140.66%
Cash Flows from Financing Activities				
Long-term Borrowings	$ 1,205,000	$ 920,352	284,648	30.93%
Repayments of Long-Term Debt	$ (725,000)	$ (890,000)	165,000	-18.54%
Issuance of Common Stock	$ 101,198	$ 100,822	376	0.37%
Cash Dividends	$ (178,000)	$ (155,000)	(23,000)	14.84%
Net Cash Provided by (Used In) Financing Activities	$ 403,198	$ (23,826)	427,024	-1792.26%
Change in Cash and Cash Equivalents	$ (200,750)	$ (88,825)	(111,925)	126.01%
Cash and Cash Equivalents, beginning of year	$ 2,712,290	$ 2,801,115	(88,825)	-3.17%
Cash and Cash Equivalents, end of year	$ 2,511,540	$ 2,712,290	(200,750)	-7.40%

Teaching Note/Instructor Manual available from the Journal of Business Cases and Applications